BANQUE
ERIC STURDZA

MONTHLY NEWSLETTER
FEBRUARY 2024

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1. EDITORIAL

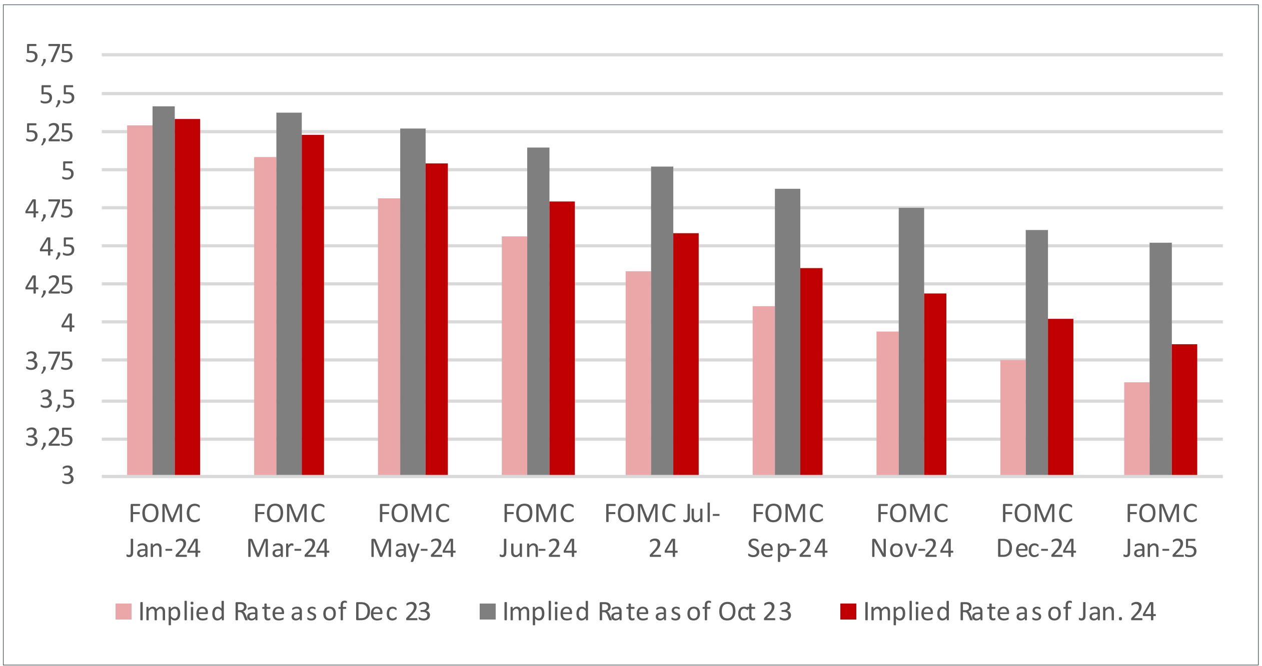
ONCE AGAIN?

This adage comes to mind in January, as this first month of 2024 saw the pursuit of some of the trends seen last year, either with rising long term rates, or the continued slide of the Chinese economy, not to mention reinforcing concentration of the US market around the "Magnificent Seven".

Rising long term rates is the point that surprises us the least. Given the magnitude and the speed at which rates fell since late October 23, the continuation of this trend at the same pace seemed pretty unrealistic, especially as far from showing a slowdown in economic activity and inflation, the latest economic data indicate the opposite (Q4 GDP and CPI are above expectations). This adjustment in long rates should be seen more as the market taking a breather than as reflecting a change of tone on the part of the Federal Reserve. Today, the priority is on growth and job preservation, a priority that is reinforced in an election year. Nevertheless, with up to 6 rate cuts anticipated by the market, the return to more realistic expectations in line with the 3 rate cuts indicated by J. Powell could be quicker than expected. This promises further volatility in rates.

More surprising is the continued concentration phenomenon seen on the US market. Whereas most of the 2023's appreciation was explained by multiple expansion, and an oversized performance impact of the 'Magnificent Seven', the year-end rally brought some relief with market breadth improving and other stocks than the 'Magnificent Seven' starting to pick up, raising hopes of a normalization process. With the S&P500 beating new highs this year, while its 'equal weight' version is treading water, the fear of a repeat of 2023 is spreading. A closer look nonetheless reveals several cracks: Apple which has little to do with AI is flat to slightly down and Tesla is falling sharply... It signals that last year's market darlings may be vulnerable, es-

G1 : FED FUNDS IMPLIED RATES AS OF JAN. 24, DEC. 23 AND OCT. 23



Source: Bloomberg, Banque Eric Sturdza pecially if the growth prospects promised by Artificial Intelligence are slow to materialize...

This year, it's also hard to overlook the disappointing performance of the Chinese market that follows a very poor one in 2023. Admittedly, the Chinese market remains "weighed down" by the ongoing real estate crisis, but the difficulties are nothing new this year. Similarly, the latest macro-economic data may seem uninspiring in the light of already low expectations, but they are not that bad in a world where growth is scarce and sluggish. Even on the geopolitical front, few new elements seem to justify such a poor performance: As expected, the Taiwanese elections gave victory to the DPP candidate, the more pro-independence party, while the DPP lost its majority in the Parliament. More fear than pain… In this environment, the major culprit might be China's authorities: Their damaged market and economic credibility, as well as their failure to provide visibility through ambitious stimuli plans and measures clearly play a role. While these points are frustrating from an investor's point of view, they can also translate into opportunities as Chinese stocks that are now trading at depressed valuation have shown their ability to rebound mid-month when the government announced some support measures. This is a reason for us to remain patient.

While the start of the year might suggests that, in many respects, 2024 is shaping up to be a repeat of 2023, the underlying situation looks very different: Central bankers have pivoted, and even if investors' rate cuts expectations were overly ambitious late last year, the still-dominant 'Magnificent Seven' group seems less impressive individually. Finally, with the events in the Red Sea and the first elections of the year, January marks the return to centre stage of political and geopolitical risks that we will have to factor more in our investment thinking in 2024.

2. FIXED INCOME

"UNBUNDLING" THE BARBELL STRATEGY

Fed - ECB, who's going to cut first?

The publication of US GDP for the fourth quarter of 2023 once again demonstrated the strength and resilience of the US economy, with a 3.3% annualized print versus 2% expected by the markets. If growth holds up at these levels, we'll be closer to the three rate cuts envisioned by the Fed at the December's FOMC than the five or six priced by markets' participants at that time. Logically, this explains January's small correction in both long term rates and fixed income performance.

The danger was to cut rates either too early or too late. Too early, and inflation takes off again. Too late, and a recession follows.

The ECB admitted that there had been a noticeable slowdown in the Euro Zone, but added that it was temporary and it is confident that growth will pick up again within a few weeks. According to François Villeroy de Galhau, the Governor of the Banque de France, inflation will return to 2% by early 2025, and the ECB will lower rates this year (though without specifying the extent or timing). The French central banker added that the danger was to cut rates either too early or too late. Too early, and inflation takes off again. Too late, and a recession ensues. We could not put it better ourselves!

In the US, the macro picture of growth and inflation is a little too hawkish and the Fed a little too dovish, whereas in the Eurozone it's the other way around! The Fed will cut rates first, followed by the ECB, which has been unable to shake off its Fed follower status.

The new 5-year 'sweet spot'

On the US Treasuries market, we long advocated a so-called "Barbell" strategy, favouring significant investments in short-dated bonds (under 2 years, or even 18 months) with very attractive yields, combined with positions in longer dated bonds – 10, 20 and especially 30-year notes. This strategy paid off handsomely in the last two months of 2023, adding substantial capital gains on the long side to the yield clipped on short term rates. Today, such a strategy seems less relevant as the Fed's first rate cuts will sooner or later materialize. As a result, it now seems absurd to us to have no exposure at all to 5-year paper, when this point of the curve is becoming the "sweet spot".

We have therefore begun to unbundle our "Barbell strategy" and reshuffle our US Treasuries' exposure by slightly reducing the long end and then selling short-term positions to finance the purchase of 5-years' notes, half in 5-year nominal yields above 4% and half in 5-year TIPS real yields of 1.8% (i.e. inflation +1.8%). Over the next few months, we'll have to decide whether to favour nominal or real rates, in order to keep this initial 50-50 strategy alive. Evolving inflation expectations will be our guide.

3. EQUITIES

THE 'MAGNIFICENT' DISPERSION

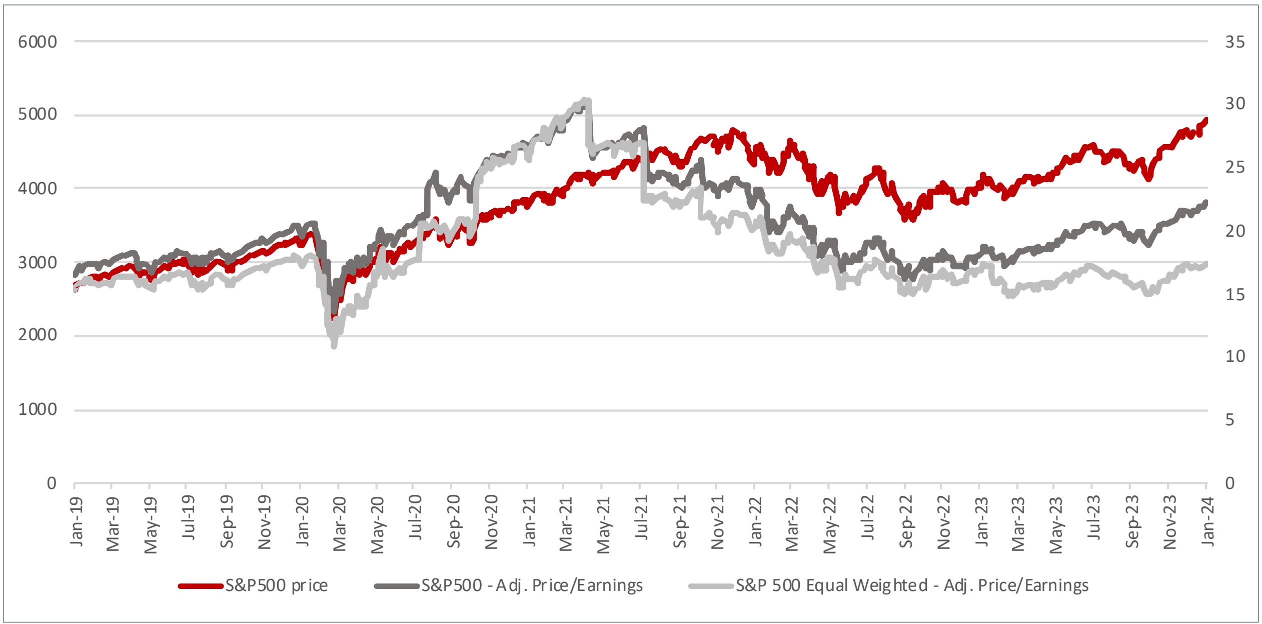
The year has got off to a good start for equities (MSCI AC World +1.5% to 29.01.2024), with the S&P500 setting the tone. After a little hesitation, the flagship index reached an all-time high and seems to be heading for the 5,000 level, still buoyed by large-cap technology stocks and the Magnificent Seven group. For now, this trend results from some new multiple expansion, a trend that will have sooner or later have to be reconciled with earnings growth.

The S&P500 now exceeds a price/earnings ratio of 23x, compared with its average of 19x over the last 10 years. The "S&P 500 Equally Weighted" index, on the other hand, shows more decent valuations, with a price/earnings ratio of 17x, in line with its historical average (graph 2). This gap continues to reflect the high concentration in the US main benchmark index. The S&P500's performance continues to be underpinned by the Seven Magnificent, with only six of the seven left as Tesla dropped out of the race with its share price down 26% YTD.

The earnings season is well underway, and so far 25% of S&P500 companies have completed the exercise. The major technology and internet companies are unveiling progressively their figures for the last quarter. These are closely scrutinized by investors, given their preponderant weight in US indices and, by extension, in global indices.

It's still too early to draw conclusions, but the surprises relative to expectations are positive for the time being, particularly in terms of earnings. Note, however, the downturn in EPS growth driven by the Materials (-25%) and Energy (-28%) sectors. Expectations are high, with earnings per share growth (S&P500) expected at +5.2% for the next 12 months, +12.8% for 2025 and +10.20% for 2026. At current valuations, there's no room for error.

G2 : S&P500 INDEX (LHS) VS. S&P500 P/E AND S&P500 EQUAL WEIGHT S&P500 P/E (RHS)



Source : Bloomberg, Banque Eric Sturdza

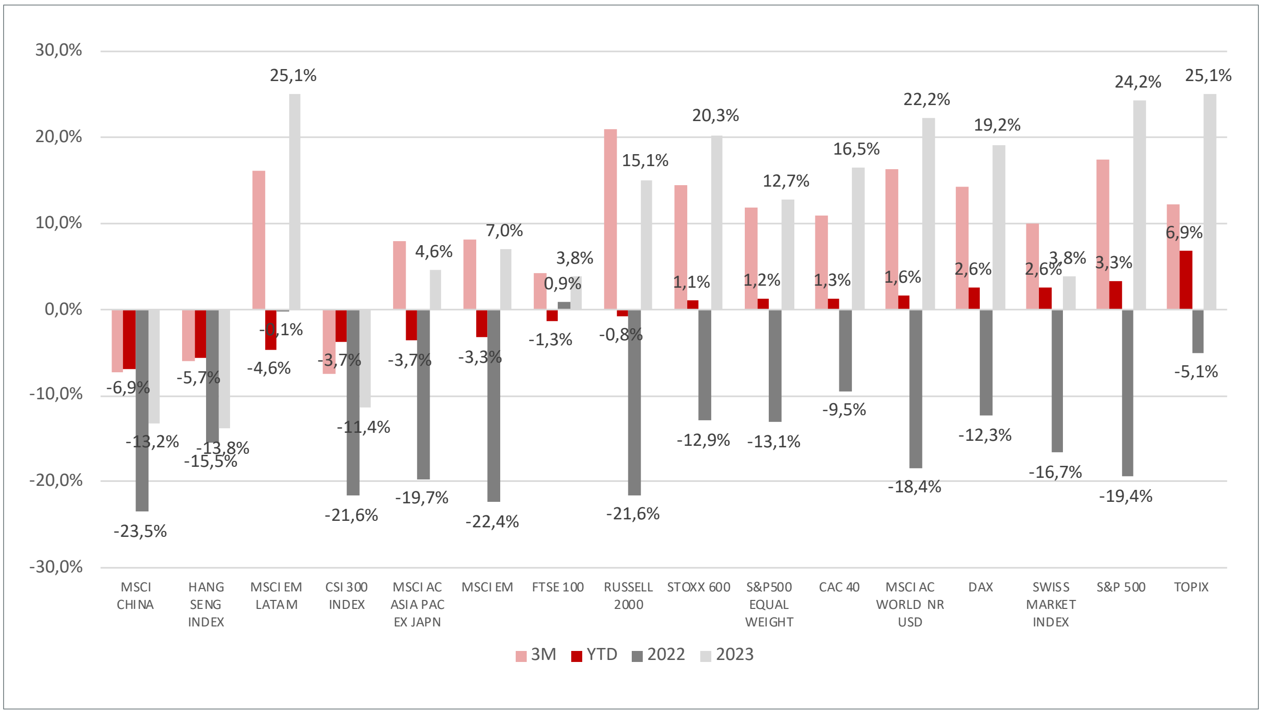
In China, President Xi Jinping continues to provide support for economic recovery. After the 20 measures unveiled in July 2023 to stimulate consumption, support housing and businesses, including green growth, the government has just added 1 trillion yuan ($139 billion) of liquidity to the market and lowered the mandatory reserve ratio (RRR) of the country's banks.

Confidence is not yet restored, however. The domestic market is sliding by almost 4% this year, and the Hang Seng by 5.7% (29.01.2024), at a time when the Chinese authorities are once again preparing to restrict the use of short selling. China remains one of the world's main economic growth engines, with GDP up by 5.3% in 2023 and expected to rise by 4.6% in 2024 (graph 2).

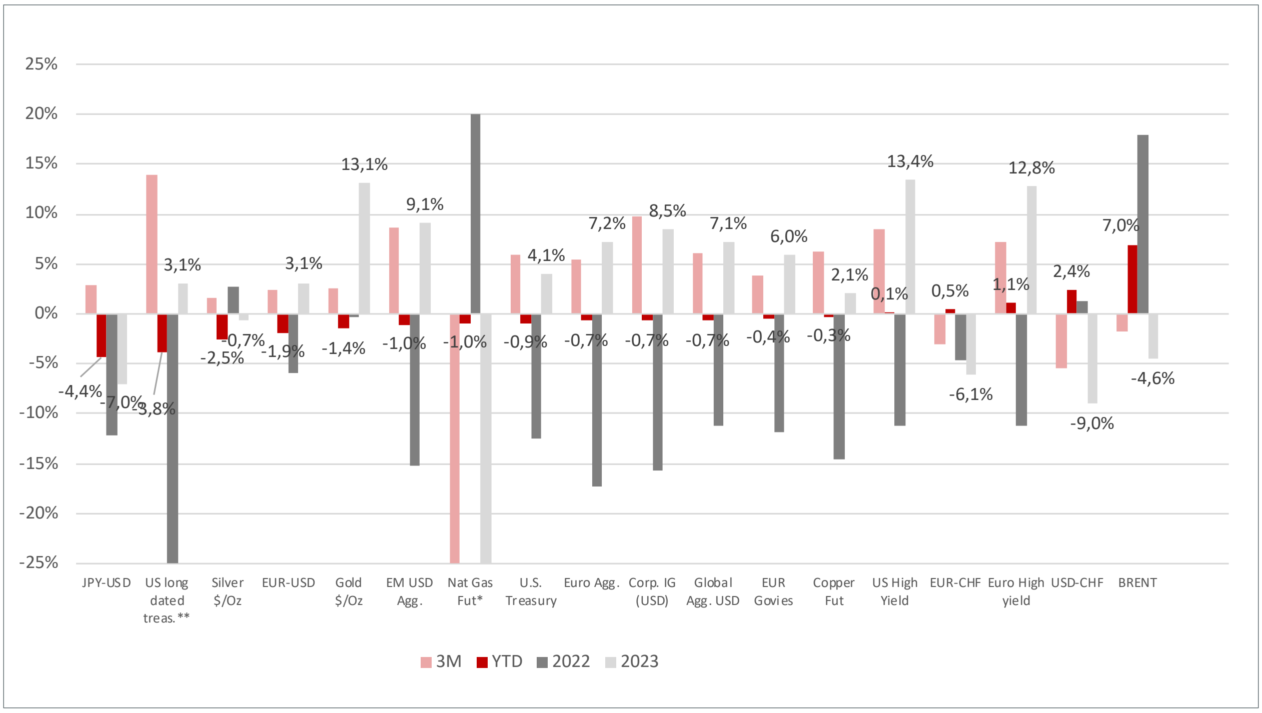
If central bankers succeed in regulating inflation without triggering a recession, the equity market could continue to rise, albeit at the pace of potentially sharp movements generated by forthcoming political (elections) and geopolitical (areas of conflict and military instability) events. We remain optimistic, paying close attention to the evolution of macroeconomic data and, in particular, to the rhetoric used by central bankers.

5. PERFORMANCES

EQUITIES IN LOCAL CURRENCIES



FIXED INCOME, CURRENCIES AND COMMODITIES



Source : Bloomberg, Banque Eric Sturdza, 31/01/2024

** Natural Gas: -43.8% 2023*
*** Long Dated Treasuries: -29.3% 2022*

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