INDOSUEZ WEALTH MANAGEMENT

CIO PERSPECTIVES

Alexandre Drabowicz - Chief Investment Officer

7 May 2024

Lower for later

The US inflation has continued to surprise on the upside since the beginning of the year. This stickiness has put the spotlight back on the uncertainties surrounding the outlook for inflation and rate cuts by the Federal Reserve (Fed), with the market appearing to give increasing consideration to a possible "reverse pivot" by the US central bank. This dynamic is weighing on the markets, but it also highlights the diverging dynamics with the Euro Area, which seems to be embracing the prospects of smooth disinflation, which should allow the European Central Bank (ECB) to initiate a cycle of rate cuts before the Fed, a historic event. Against this backdrop, we are taking a tactically neutral view on equities in a market that should offer attractive entry points at some point, while our strategic stance remains positive. At the same time, the recent rates rise makes duration more relevant in diversified portfolios, while we maintain a tactically positive view on the US dollar.

The US inflation is a short-term challenge but the direction remains the same

The year 2023 ended on an optimistic note, with unfailing growth and almost immaculate disinflation. Q1 2024 will have seen the opposite dynamic, with growth slowing from 4% (quarter-on-quarter, annualised) in H2 2023 to 1.6% and Core PCE accelerating from 1.6% (quarter-on-quarter, annualised) in Q4 2023 to 4.4% in Q1 2024. Growth is normalising, although the weakness of the Q1 2024 figure in the US is largely due to volatile factors (net trade and inventories). In fact, from a domestic point of view, the US economy remained very robust in the first quarter, with private domestic final purchases (excluding net trade, inventories and government spending) rising by 3.1% (annualised) after 3.3% in the previous quarter. Notably, the consumer continues to show resilience, buoyed by a steady improvement in purchasing power, wealth effects thanks to rising equity markets and property prices in recent months, high-interest savings, and a labour market whose strength reflects, in particular, the impressive rise in immigration to the US in recent years (+3.3 million immigrants by 2023). This last point is particularly key, as it is helping to make up for some of the labour shortages that companies have had to deal with in the wake of the pandemic, a feature that has exerted significant pressure on wages in the United States.

The big question mark lies more with inflation, which showed major signs of rigidity in Q1 2024, causing the markets to sit on five of the seven rate cuts that were anticipated for 2024 at the start of the year. Core PCE has now stagnated for three months at 2.8% (year-on-year, annualised), a big improvement on the 5.2% that prevailed at the end of 2022 but still a long way from the Fed's 2% target. This stickiness is reflected in the services component, where a combination of seasonality (particularly with the price rises generally seen in services at the start of the year), delayed effects on specific components (shelter, medical and auto insurance) and the rise in financial services prices (reflecting the market rally over the last few months) has called into question the disinflation process.

The road could be bumpier than expected at first, but we continue to believe that the direction is towards further disinflation in the US in 2024. Indeed, the current stickiness is not necessarily the result of the strength of the US economy, the underlying dynamics continuing to point towards further disinflation.

Firstly, the shelter component is following rent prices with a lag of almost one year, and rents have fallen sharply since peaking in 2022. This dynamic is not fully reflected in the PCE, where housing inflation was still at 5.8% in March, which should justify a first leg of disinflation in 2024. Secondly, the fundamentals continue to point to a continuation of disinflation in services: the labour market is rebalancing, wages growth continue to normalise and inflation expectations remain relatively moderate.

Ultimately, our scenario continues to paint a picture of a soft landing for the US economy over the coming quarters, for which we expect growth and core inflation (Core PCE) of 2.5% (annual average) and 2.8% respectively in 2024 and 1.8% and 2.3% in 2025.

Renewed optimism in the Euro Area and transatlantic divergences

In the Euro Area, activity indicators have picked up strongly in recent months, as shown by the Composite PMI, which came back in expansion territory in March, driven by the improvement seen in the services sector, while manufacturing is currently holding back activity, particularly in Germany. This dynamic is in line with our scenario of a recovery in growth in the Euro Area from H1 2024 onwards, with GDP rising by 0.3% in Q1 2024, above the 0.1% expected by the consensus. For several months now, this optimistic outlook for the Old Continent has been based in particular on expectations of a recovery in consumption in the Euro Area, supported by an increase in household purchasing power as wages catch up with inflation, which has been decelerating for several quarters now. We expect disinflation to continue over the course of 2024 and into 2025, although headline inflation is likely to appear somewhat bumpy due to technical effects on energy, while underlying inflation should benefit in particular from a slowdown in the services component, which, like in the US, remains high at 3.7%.

These prospects for smooth disinflation highlight the divergence on the inflation front between the Euro Area and the United States, symbolising an economy on the Old Continent characterised by relatively modest demand, credit conditions that remain restrictive in a strongly bank-based economy, fiscal policies that are less expansionary than on the other side of the Atlantic, and deflation imported from China. This divergence is reflected in the revisions we have made to our inflation scenario since the start of the year. At the end of 2023, we were expecting inflation in the Euro Area and the United States (Headline CPI) to average 2.9% and 2.7% respectively on an annual basis in 2024; the tables have turned since then and we are now expecting 2.3% in the Euro Area and 3% in the United States.

In 2024, the Old Continent's economy should continue to recover, supported by the recovery of real wages, but also by the easing of monetary conditions and an improvement in the global manufacturing cycle. Therefore, we expect growth to average 0.6% in 2024 and 1.2% in 2025. Moreover, inflation in the Euro Area should be close to 2% during 2024, stabilising around the ECB’s target in 2025, particularly on the underlying component.

However, this optimistic scenario is also accompanied by risks to growth and inflation. To begin with, even if real income improves, household sentiment is still sluggish, with savings intentions still high, which could delay the recovery in consumption. In addition, deficits relative to GDP of 5.5% in France and 7.2% in Italy in 2023 have brought back to the fore fears about the debt sustainability in the Euro Area, and could lead to more restrictive fiscal stances. On the inflation front, the possible repercussions on energy prices of geopolitical tensions in the Middle East and a weaker euro, as a result of the ECB cutting rates ahead of the Fed, could lead to upward pressure on prices, particularly headline inflation.

FOMC review and policy rate path

After pivoting in late 2023, the first CPI prints of the year did not confirm the positive *momentum* on disinflation and forced Jerome Powell to dial back rate cuts expectations even if the March dot plot still points to three cuts in 2024. Against this macro backdrop, the chair of the Fed was in a tough spot for the May Federal Open Market Committee (FOMC) but managed to communicate in a balanced way by acknowledging the need to keep rates at the actual level for some time and also avoiding rushing into the hiking rates scenario. Jerome Powell laid out three policy paths depending on the three following macro scenarios:

1. Sideways inflation and prolonged labour market strength that will lead to federal fund rates staying at the actual level,
2. A goldilocks scenario in which the Fed cuts rates to preserve the soft landing (this one is our base case scenario),
3. A more growth bearish scenario with weakening of labour market that pushes the Fed to cut more aggressively.

This guidance is interesting as it cuts off the tails of the federal fund rates pricing and keeps a cap on the front end. It also shows a change of perspective at the Fed. Now that inflation is in the 3% area, preserving a strong labour market gains in importance. The Fed is now putting emphasis on its dual mandates.

In the May edition of our Monthly House View, we acknowledged that the Fed might take longer to cut but that policy rate is restrictive and keeping this stance will likely tighten financial conditions.

Higher forever or lower for later?

Market kept oscillating between recession/soft landing pricing and higher for longer pricing in short-term interest rates since 2022. This rate hiking cycle has surprised most market participants and forecasters thanks to a strong US consumer, less rate sensitivity and overall strong nominal growth. The economy has been growing at a higher pace than its potential for quite some time raising the question of neutral rate and if it is higher in the post-pandemic world. Economists try to put an estimate on R*[1] through models that give a wide scope of outputs. Real R* is between 0.8% and 2.5% depending on the model and the average is around 1.5% for the US economy.

On the inflation front, the last mile to reach the 2% target is proving to be more difficult and takes more time. Inflation progress stalled in 2024 and Core PCE is still far above 2%. However, we still expect continued disinflation in the coming months and Core PCE to be between 2 and 2.5% by end 2025. A major risk to this forecast is rent disinflation.

Given these two assumptions, we think the terminal rate for the Fed is around 4%, in the current cycle. It implies 150 basis points (bps) of cuts, when the market only prices 120 bps of cuts by end of 2025. We have been expecting rates to be higher for longer and been expecting less cuts than the market since the end of 2022. Our expectations on US growth have been higher than the consensus and were the main factor to explain our stance on federal funds rates. Also, this is the first time that the market pricing is more hawkish than the Fed dot plots.

Are we at ease with being more dovish this time? The answer is yes!

Monetary policy theory suggests that rate hikes take time to affect the economy. We have observed in this cycle a rapid pass-through of monetary policy through tightening of financial conditions and bank lending channel but the excessive pricing of cuts reversed that effect.

It is important to differentiate between actual data and market pricing. Last year, data were strong but most economists kept expecting a recession and large cuts. The fiscal impulse was positive and financial conditions did loosen post Silicon Valley Bank (SVB), it fuelled nominal growth. Today, the fiscal side is less supportive, financial conditions are tightening, growth expectations are high, and short-term interest rates are pricing a higher for longer policy path. This combination of factors reassure us in our stance. Tighter financial conditions for a sufficient period will create the environment for rate cuts.

While we can debate if July or September will be the first meeting where the FOMC cuts, we think the focus is much more on when we can reach the terminal rate. Based on our growth and inflation forecasts this could be by end of 2025, which means that depending on the next labour and inflation data we could see one to three rate cuts this year, so three to five cuts next year based on our terminal rate scenario. Hence, the federal funds landing is much more important than the next month's expectations.

---

[1] R* Neutral rate: it is the long-run *equilibrium* interest rate which is the short-term interest rate that would prevail when the economy is at full employment and stable inflation.

Federal Reserve Balance sheet and Treasuries supply/demand dynamics

The Fed did also disclose its plans regarding its balance sheet. The Fed currently lets 60 billion dollars in Treasuries mature each month without replacing them, reducing the amount of liquidity in the banking system. Quantitative Tightening (QT) can help exert some downward pressure on prices by expanding risk premium in the market.

The 1st of May, the FOMC announced slowing the pace of the balance sheet reduction by lowering the runoff cap from 60 billion to 25 billion dollars in treasuries. A dovish surprise from the FOMC. By not replacing the treasuries that mature, the Federal Reserve removes a buyer from the treasuries market. So by tapering 35 billion dollars a month the QT, the Fed exerts a positive impact on supply/demand by 420 billion dollars in a one year horizon.

At the same time, the US treasury announced its funding plans for the third quarter. It was largely as expected with unchanged nominal coupon auction sizes. The US deficit keeps weighing on the US treasury issuance plan, even if nominal coupon auction sizes stays the same, the amounts are huge.

We have been writing about the term *premia* since last year given its abnormal negative level translating in an absence of compensation for holding long-term bonds. We still think that the term *premia* is too low to compensate investors for holding long-term bonds, especially in front of so much supply. We believe that the condition to make this part of the curve attractive (in the absence of recession) is a positive yield curve slope with a higher term *premia*.

Did the last FOMC and Treasury Quarterly Refunding Announcement change our view? Not really, even though we acknowledge that a QT taper combined with stable coupon auction sizes help smooth the repricing of the longer end, contrary to last summer price action. Combined, they remove some tail risk on US treasuries pricing but the pressure on bonds will still be there as supply comes to the market. Another factor that could weigh on long-term rates is policy rate path. Assuming no recession, if inflation stays higher than 2% and the FOMC refrains from hiking rates again, they will likely contribute to a higher inflation risk premium.

Overall, the last developments on the US treasury market comfort us in our positive view on the front end of the yield curve. 2-year yields are likely to stay pinned around 5% for the time being. While the long end drivers are much more balanced with efforts from policy makers to smooth volatility, but term *premia* is still low. Our fair value estimate on the US 10-year yield is around 4.75% with upside risks given our growth scenario. As a result, we think the path of least resistance for the yield curve is to steepen.

ECB is ready to fly with its own wings

The Euro Area is experiencing a different inflation story. As explained in our macroeconomic scenario, the ECB will have the conditions to start cutting rates as soon as this summer. The June meeting is clearly identified as probable for a first rate cut. Remaining cautious, the ECB maintains that it wants to see progress in terms of wage increases (i.e. a rate of progression more in line with inflation at 2%) and indicates that updating its macroeconomic projections will be useful to support this first reduction in key rates. Another element of attention for the ECB is the oil price. Recent geopolitical tensions have propelled the price of a barrel above 80 dollars, which is higher than the assumptions made by the ECB in its recent projections. For the moment, this element remains at the risk stage and the various projections on inflation in the Euro Area seem to point towards an environment favourable to rate cuts. In terms of neutral rate estimates, the Euro Area economy is different as well from the US. Post-pandemic factors did not materially alter the outlook on growth. Neutral rate's estimates are somewhere between 0 and 0.5% while inflation is projected to be at target as soon as next year. ECB's terminal rate is unlikely to go back to pre-pandemic levels and should stabilise around 2% in the next year. Hence, we expect gradual cuts this year starting from June and totalling 6 to 8 cuts by end of 2025. Diverging inflation dynamics on both side of the Atlantic explain the different central banks reaction function.

Allocation

Against this backdrop, the combination of the above expectations US inflation prints, upward reassessment by the markets of the trajectory of Fed rate expectations and geopolitical tensions in the Middle East weighed on equity market sentiment. On the basis of these developments, we decided to adopt a more cautious approach to risky assets, lowering our exposure to equity risk on two occasions, in March and April, leading us to adopt a neutral view on the equity markets. The sinuous and uncertain nature of inflation dynamics in the short term could continue to weigh on the markets, but given our constructive scenario for US growth, with a continuation of disinflation and the start of the Fed's rate-cutting cycle, we maintain a strategically positive view on equities and tactically see market corrections as opportunities to seize entry points. In terms of allocation, the recent rise in long-term yields means that we are now more comfortable with duration, although we are still favouring the short and intermediate parts of the curve, with a preference for the Euro Area because of the divergences in nominal growth and monetary policy between the two zones. These divergences also justify maintaining our tactically positive view on the dollar, which also represents a hedge against two main risks in our scenario: a stickier-than-expected inflation in the United States and escalating tensions in the Middle East.

Alexandre DRABOWICZ
Chief Investment Officer

Lucas MERIC
Investment Strategist

Yasser TALBI
Fixed Income Portfolio Manager

DISCLAIMER

This document entitled "CIO Perspectives" (the "Publication") is issued for marketing communication only.

The languages in which it is drafted form part of the working languages of Indosuez Wealth Management.

The information published in the Publication has not been reviewed and is not subject to the approval or authorisation of any regulatory or market authority whatsoever, in whatever jurisdiction.

The Publication is not intended for or aimed at the persons of any country in particular. The Publication is not intended for persons who are citizens, domiciled or resident in a country or jurisdiction in which its distribution, publication, availability or use would contravene applicable laws or regulations. This document does not constitute or contain an offer or an invitation to buy or sell any financial instrument and/or service whatsoever. Similarly, it does not, in any way, constitute a strategy, personalised or general investment or disinvestment recommendation or advice, legal or tax advice, audit advice, or any other advice of a professional nature. No representation is made that any investment or strategy is suitable and appropriate to individual circumstance or that any investment or strategy constitutes a personalised investment advice to any investor.

The relevant date in this document is, unless otherwise specified, the editing date mentioned on the last page of this disclaimer. The information contained herein are based on sources considered reliable. We use our best effort to ensure the timeliness, accuracy, and comprehensives of the information contained in this document. All information as well as the price, market valuations and calculations indicated herein may change without notice. Past prices and performances are not necessarily a guide to future prices and performances.

The risks include, amongst others, political risks, credit risks, foreign exchange risks, economic risks and market risks. Before entering into any transaction you should consult your investment advisor and, where necessary, obtain independent professional advice in respect of risks, as well as any legal, regulatory, credit, tax, and accounting consequences. You are advised to contact your usual advisers in order to make your decisions independently, in light of your particular financial situation and your financial knowledge and experience

Foreign currency rates may adversely affect the value, price or income of the investment when it is realised and converted back into the investor's base currency.

CA Indosuez a French company, the holding company for the Crédit Agricole group's wealth management business, and its related subsidiaries or entities, namely CA Indosuez (Switzerland) SA, CA Indosuez Wealth (Europe), CFM Indosuez Wealth, their respective subsidiaries, branches, and representative offices, whatever their location, operate under the single brand Indosuez Wealth Management. Each of the subsidiaries, their respective subsidiaries, branches, and representative offices, as well as each of the other Indosuez Wealth Management entities are referred to individually as the "Entity" and collectively as the "Entities".

The Entities or their shareholders as well as its shareholders, subsidiaries, and more generally companies in the Crédit Agricole SA group (the "Group") and respectively their corporate officers, senior management or employees may, on a personal basis or in the name and on behalf of third parties, undertake transactions in the financial instruments described in the Publication, hold other financial instruments in respect of the issuer or the guarantor of those financial instruments, or may provide or seek to provide securities services, financial services or any other type of service for or from these Entities. Where an Entity and/or a Crédit Agricole Group Entity acts as an investment adviser and/or manager, administrator, distributor or placement agent for certain products or services mentioned in the Publication, or carries out other services in which an Entity or the Crédit Agricole Group has or is likely to have a direct or indirect interest, your Entity shall give priority to the investor's interest.

Some investments, products, and services, including custody, may be subject to legal and regulatory restrictions or may not be available worldwide on an unrestricted basis taking into consideration the law of your country of origin, your country of residence or any other country with which you may have ties. In particular, any the products or services featured in the Publication are not suitable for residents of US and Canada. Products and services may be provided by Entities under their contractual conditions and prices, in accordance with applicable laws and regulations and subject to their licence. They may be modified or withdrawn at any time without any notification.

Please contact your relationship manager for further information.

In accordance with applicable regulations, each Entity makes the Publication available:

- **In France:** this publication is distributed by CA Indosuez, a public limited company with a capital of 584'325'015 euros, a credit institution and an insurance brokerage company registered with the French Register of Insurance Intermediaries under number 07 004759 and with the Paris Trade and Companies Register under number 572 171 635, whose registered office is located at 17, rue du Docteur Lancereaux - 75008 Paris, and whose supervisory authorities are the Prudential Control and Resolution Authority and the Autorité des Marchés Financiers.

- **In Luxembourg:** the Publication is distributed by CA Indosuez Wealth (Europe), a limited company (société anonyme) under Luxembourg law with share capital of euros 415.000.000, having its registered office at 39 allée Scheffer L-2520 Luxembourg, registered with the Luxembourg Companies Register under number B91.986, an authorized credit institution established in Luxembourg and supervised by the Luxembourg financial regulator, the Commission de Surveillance du Secteur Financier (CSSF).

- **In Spain:** the Publication is distributed by CA Indosuez Wealth (Europe) Sucursal en Espana, supervised by the Banco de Espana (www.bde.es) and the Spanish National Securities Market Commission (Comision Nacional del Mercado de Valores, CNMV, www.cnmv.es), a branch of CA Indosuez Wealth (Europe), a credit institution duly registered in Luxembourg and supervised by the Luxembourg financial regulator, the Commission de Surveillance du Secteur Financier (CSSF). Adress: Paseo de la Castellana numero 1, 28046 Madrid (Spain), registered with the Banco de Espana under number 1545. Registered in the Madrid Trade and Companies Register, number T 30.176,F 1,S 8, H M-543170, CIF (Company tax ID) : W-0182904-C.

- **In Belgium:** the Publication is distributed by CA Indosuez Wealth (Europe) Belgium Branch, located at 120 Chaussée de la Hulpe B-1000 Brussels, Belgium, registered with the Brussels Companies Register under number 0534 752 288, entered in the Banque-Carrefour des Entreprises (Belgian companies database) under VAT number 0534.752.288 (RPM Brussels), a branch of CA Indosuez Wealth (Europe).

- **In Italy:** the Publication is distributed by CA Indosuez Wealth (Europe), Italy Branch based in Piazza Cavour 2, Milan, Italy, registered in the Register of Banks no. 8097, tax code and registration number in the Business Register of Milan, Monza Brianza and Lodi n. 97902220157.

- **Within the European Union:** the Publication may be distributed by Indosuez Wealth Management Entities authorised to do so under the Free Provision of Services.

- **In Monaco:** the Publication is distributed by CFM Indosuez Wealth, 11, Boulevard Albert 1er - 98000 Monaco registered in the Monaco Trade and Industry Register under number 56S00341, accreditation: EC/2012-08.

- **In Switzerland:** the Publication is distributed by CA Indosuez (Switzerland) SA, Quai Général-Guisan 4, 1204 Geneva and by CA Indosuez Finanziaria SA, Via F. Pelli 3, 6900 Lugano and by their Swiss branches and/or agencies. The Publication constitutes marketing material and does not constitute the product of a financial analysis within the meaning of the directives of the Swiss Bankers Association (SBA) relating to the independence of financial analysis within the meaning of Swiss law. Consequently, these directives are not applicable to the Publication.

- **In Hong Kong SAR:** the Publication is distributed by CA Indosuez (Switzerland) SA, Hong Kong Branch, Suite 2918, Two Pacific Place, 88 Queensway. No information contained in the Publication constitutes an investment recommendation. The Publication has not been referred to the Securities and Futures Commission (SFC) or any other regulatory authority in Hong Kong. The Publication and products it may mention have not been authorised by the SFC within the meaning of sections 103, 104, 104A or 105 of the Securities and Futures Ordinance (Cap. 571) (SFO).

- **In Singapore:** the Publication is distributed by CA Indosuez (Switzerland) SA, Singapore Branch 168 Robinson Road #23-03 Capital Tower, 068912 Singapore. In Singapore, the Publication is only intended for persons considered to be high net worth individuals in accordance with the Monetary Authority of Singapore's Guideline No. FAA-G07, or accredited investors, institutional investors or expert investors as defined by the Securities and Futures Act, Chapter 289 of Singapore. For any questions concerning the Publication, recipients in Singapore can contact CA Indosuez (Switzerland) SA, Singapore Branch.

- **In the DIFC-UAE:** the Publication the brochure is distributed by CA Indosuez (Switzerland) SA, DIFC Branch, Al Fattan Currency House, Tower 2 – Level 23 Unit 4 DIFC PO Box 507232 Dubai – UAE a company regulated by the Dubai Financial Service Authority ("DFSA"). This brochure is intended for professional client and/or market counterparty only and no other person should act upon it. The financial products or services to which this publication relates will only be made available to a client who meets the DFSA professional client and /or market counterparty requirements. This brochure is provided for information purposes only. It is not to be construed as an offer to buy or sell or solicitation of an offer to buy or sell any financial instruments or to participate in any particular trading strategy in any jurisdiction.

- **In the UAE:** the Publication is distributed by CA Indosuez (Switzerland) SA, Abu Dhabi Representative Office, Zayed - The 1st Street- Al Muhairy Center, Office Tower, 5th Floor, P.O. Box 44836 Abu Dhabi, United Arab Emirates. CA Indosuez (Switzerland) SA operates in the United Arab Emirates (UAE) via its representative office which comes under the supervisory authority of the UAE Central Bank. In accordance with the rules and regulations applicable in the UAE, CA Indosuez (Switzerland) SA representation office may not carry out any banking activity. The representative office may only market and promote CA Indosuez (Switzerland) SA's activities and products. The Publication does not constitute an offer to a particular person or the general public, or an invitation to submit an offer. It is distributed on a private basis and has not been reviewed or approved by the UAE Central Bank or by another UAE regulatory authority.

- **Other countries:** laws and regulations of other countries may also limit the distribution of this publication. Anyone in possession of this publication must seek information about any legal restrictions and comply with them.

The Publication may not be photocopied or reproduced or distributed, in full or in part, in any form without the prior agreement of your Bank.

© 2024, CA Indosuez (Switzerland) SA / All rights reserved.

Photo credits: iStock.