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Monthly Investment Update
What's Driving Markets Higher?

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There are a number of surprising dynamics emerging across the market following the first quarter of the year. One in particular is the simultaneous rise in gold, energy, bond yields, and equities—which is unexpected especially considering the repricing of the Fed Funds rate from seven rate cuts to less than 1.5 cuts in 2024, driven by sustained growth data and the three upside surprises on the inflation rate. It is therefore important to try to explain this dynamic, to better understand what is happening in the market.

Highlights

- Another surprising dynamic has been the ongoing strength of the US dollar. Although in this case, given the positive near-term outlook for the currency, we may be talking about a 'less worse' US dollar rather than a stronger one.

- It is also important to note that inflation is normalizing not because of the weakness of the economy in the US—the situation in Europe is different with inflation near 2% and a likely rate cut in June—but because of the end of the pandemic and shocks from wars, and their effects on supply.

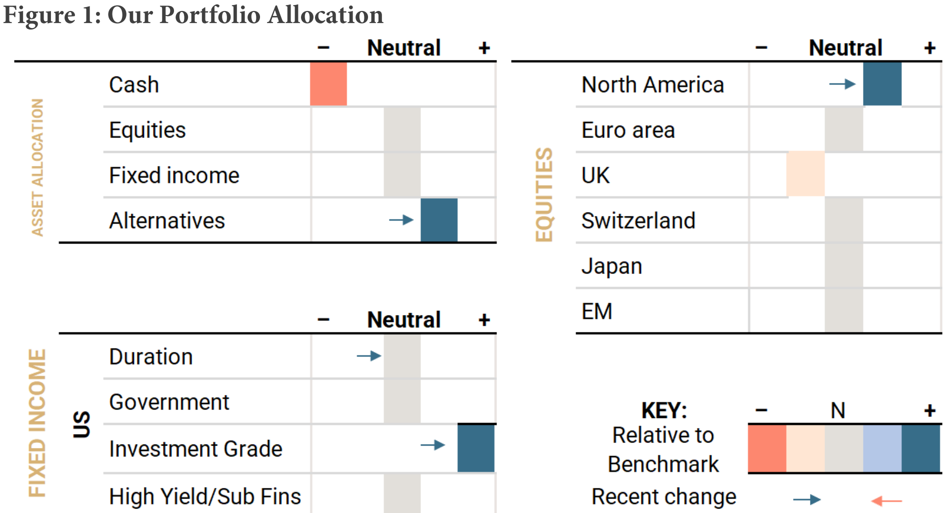
- We remain positive on equity markets—and even took advantage of recent weakness to increase our exposure. However, risks remain on the horizon including geopolitics. In addition, the major threat to equity prices belies in the pressure from higher rates.

- As far as the economy is concerned, for the moment there does not seem to be any problems with the sustainability of consumption and investment. And should fiscal support run out, this would be a good sign for the Fed.

What's Driving Markets Higher?

"The major threat to equity prices belies in the pressure from higher rates, since rates affect both the economy (higher costs to service debts) and stocks."

Figure 1: Our Portfolio Allocation



Source: Barings. As of April 26, 2024.

Another surprising dynamic has been the ongoing strength of the US dollar. However, while we fully recognize that the US has merits that justify the strength of its currency, especially in the short term, it is important to note that the world of currencies works in relative terms. In other words, given the positive near-term outlook, in this case we may be talking about a 'less worse' US dollar rather than a stronger one. In fact, for various reasons, all the (significant) alternatives to the US dollar are not at all attractive to international investors.

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For instance, China is trying to get out of a real estate-related deflationary bubble. Japan is pursuing extreme dovish monetary policies against all other central banks, indirectly manipulating the value of the Japanese yen. Europe is facing both cyclical and structural challenges: the economy has suffered more than the US with slower growth—and has been on the brink of recession for almost two years—and the European Central Bank (ECB) will likely cut rates before the Federal Reserve (Fed). On the structural side, Europe is exposed on two fronts: a major war at its border, and a huge immigration threat from Africa. In this context, political elections are taking place and populist parties could perform well, confirming their trend.

The issue of inflation is certainly the thorniest, and in our view could be the one that is more likely to bother asset prices in the coming months, rather than the risk of a growth slowdown. Having to take sides, we still think that the path toward normalization back to the 2% target will be slowed down rather than interrupted/reversed. It is also likely that given the changes related to war and protectionism, we are unlikely to see 'too low' (i.e. permanently below 2%) inflation rates in the developed world anytime soon. But this doesn't mean that inflation cannot continue to decline toward the target.

It is also important to keep in mind that inflation is normalizing not because of the weakness of the economy in the US—the situation in Europe is different with inflation near 2% and a likely rate cut in June—but because of the end of the pandemic and shocks from wars, and their effects on supply. At the same time, while we expect inflation to continue to normalize, we recognize the pace has slowed recently. **The paradox of the past year has been that inflation has decelerated while growth accelerated** (post the economic reopening). This is because the supply side has normalized, recovering its elasticity.

But two other topics are even more important than inflation: 1) the response of central banks, and 2) the reason for elevated inflation. In the current circumstances, it seems to us that both variables translate favorably for risky assets—which is what we are most interested in. When it comes to the response of central banks, the Fed appears to be moderately dovish to us, following the significant turnaround in November. It also seems quite tolerant of the three negative inflation surprises since the beginning of the year.

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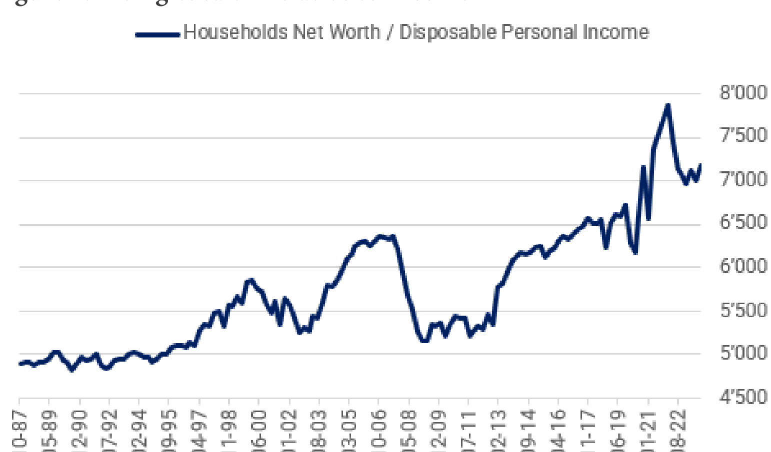
When it comes to the reason for sticky inflation, as mentioned earlier, this is strong demand—coupled with a robust labor market, high levels of confidence, and favorable financial conditions (thanks to high asset prices offsetting high interest rates).

Figure 2: Rising Wealth Relative to Income



Source: St. Louis Fed. As of April 26, 2024.

In this context, we have learned that stocks tend to do well, for a number of reasons:

1) Earnings are a nominal variable, and indeed continue to grow in line with the consensus at the start of the year (10% growth for both 2024 and 2025).

2) Productivity, which we started mentioning in the second half of 2023 as a pillar of our constructive thesis on markets, continues to rise (Figure 3), perhaps already supported by the initial impacts of AI.

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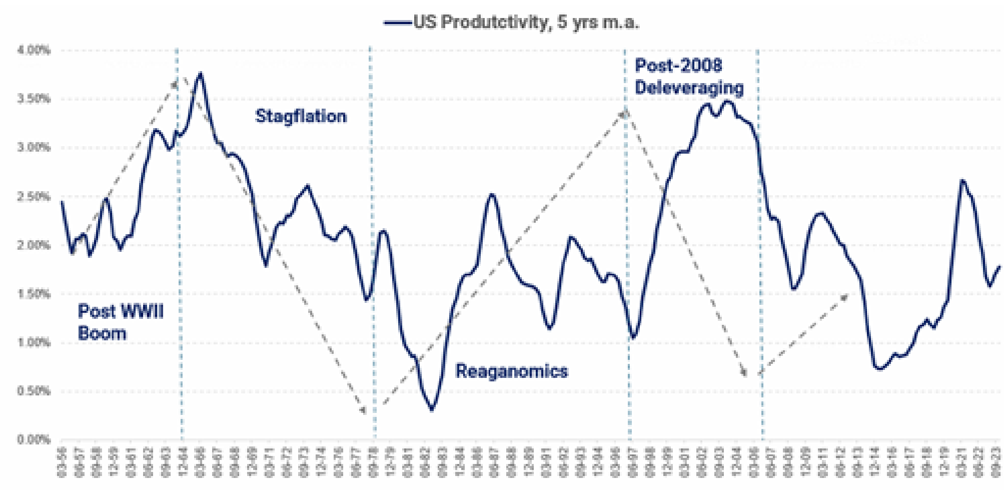
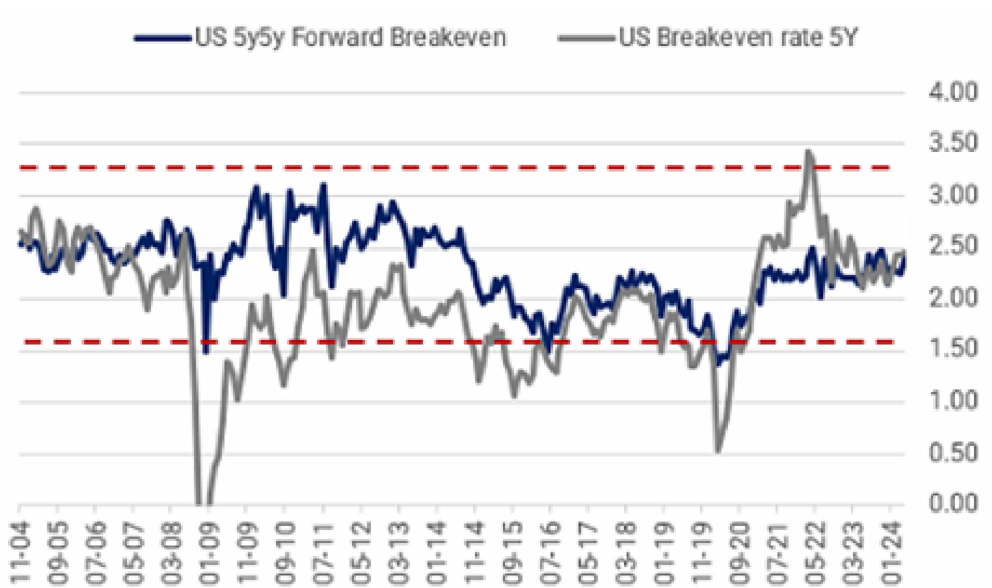
Figure 3: US Productivity Rises



Source: Bloomberg. As of April 26, 2024.

3) Rates are indeed high—compared to the recent past—but for the time being they are still under control and, above all, inflation expectations in the medium term (next five years) remain low and in their range. This is key because it shows that despite all the criticism and initial mistakes in 2021, the Fed has largely recovered its credibility.

Figure 4: Inflation Expectations Remain Low



Source: Bloomberg. As of April 26, 2024.

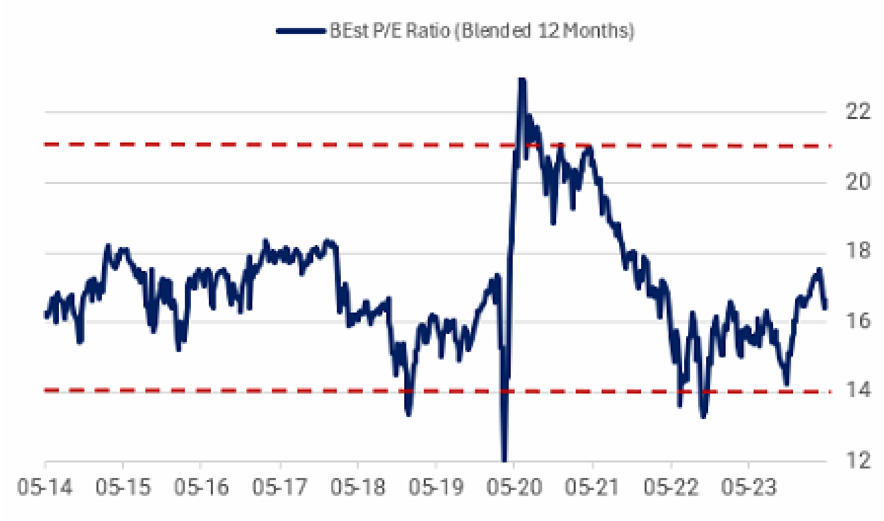
"We recognize that multiples are not low, but they are not that excessive either, if observed carefully."

4) We recognize that multiples are not low, but they are not that excessive either, if observed carefully. In fact, the S&P 500 is running around 20 on price/earnings for the next four quarters. The Mag 7 are indeed expensive around 28—albeit they have corrected in recent weeks—but we are referring to companies with very high ROEs and impressive growth rates.

The S&P 500 equal-weighted index (which we use as a proxy for the 'rest of the market' and is not influenced by the Mag 7) is around 16. This is acceptable and in line with its trend over the last few decades.

“Based on past experience, our rule of thumb is that 100 bps of rate hikes can translate into a correction of around 10% for the market.”

Figure 5: Valuations are Not Low, or Expensive



Source: Bloomberg. As of April 26, 2024.

5) We are seeing several indicators of the manufacturing sector recovering in the US, Europe and China. Although manufacturing counts for no more than 20% of the economy in the EU and US, it is the most cyclical sector, and therefore most significant for the state of the business cycle.

Risks to our Constructive Outlook

We have not mentioned geopolitics so far, which has indeed sparked volatility over the past few weeks. **However, we have learned over the years to be wary of this factor as a determinant for the longer term.** In the specific case of the Israel-Iran confrontation, we think direct war is in neither interest in the short term. Iran is not ready for a direct war, and is concentrated on building its nuclear weapons. A direct war would only threaten the regime's grip on society. Israel is still concentrated on Gaza, where it has achieved little results (Hamas defeat/hostages), while it has spoiled its external image to the rest of the democratic world. Building a larger coalition/consensus, as happened during Iran's missile attack, is more relevant to its survival.

In fact, we have dealt with the recent selloff episode, partly related to tensions in the Middle East, to increase our equity exposures in all discretionary portfolios—while advising all of our clients to follow the same path. We did not execute on the full target increase, since we recognize that the correction might not be over, especially since we are in the middle of the earnings season. Should the S&P 500 fall another 5% from the recent lows of 4,980, we would increase further as we believe the bull market is intact, and any weakness should present a buying opportunity.

The major threat to equity prices belies in the pressure from higher rates, since rates affect both the economy (higher costs to service debts) and stocks (via lower multiples). Based on past experience, our rule of thumb is that 100 basis points (bps) of rate hikes can translate into a correction of around 10% for the market. Since the movement we are witnessing started at 3.80% on the 10-year, and we are stuck at 4.60% as we write, if we were to go toward 5%, we could expect a further 5% drop in the S&P 500. This could happen in an environment where the current earnings season is less bright than expected—not least because year-on-year comparisons are starting to become more difficult, following the sharp recovery of the past two years.

As far as the economy is concerned, we note that for the moment there does not seem to be any problems with the sustainability of consumption and investment. And should fiscal support (which has fueled excess savings since Covid) run out, this would be a good sign for the Fed.