MARKETING DOCUMENT | MAY 2024

UBP House View

Union Bancaire Privée

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The search for carry

The longer-than-expected disinflationary process and increasing tensions in the Middle East undermined the equity and bond markets in April. The lingering pressure on prices alongside the resilience of the US economy suggests that the Federal Reserve will probably keep its main interest rate higher for longer. Considering these recent developments, should we reassess the validity of our ongoing scenario?

Given global inflation of 3%, our latest forecast suggests a decline to a range of 2–2.5% during the first quarter of 2025, rather than in the coming quarters as previously anticipated. Our scenario remains the same, but this revision increases the likelihood of the easing cycle starting in the second part of this year.

As an important component of inflation indicators, we are closely monitoring the fluctuation in gold and oil prices amid mounting geopolitical risks.

In response to elevated interest rates, we leverage a carry strategy to capitalise on rate differentials within the fixed-income space, recognising that the era of capital gains on credit is behind us. As a result, we strengthened our conviction on high yield from 3 to 4.

We also adjusted our rating on Chinese equities from 1 to 2, as we are tactically more constructive. However, we remain cautious due to the lack of visibility and corporate earnings transmission to shareholders.

Key Takeaways

1 INFLATION

Global inflation has declined since its peak of 8% during the third quarter of 2022, but it is slow to fall below the threshold of 3%. We will need to wait until 2025 to see it return to around 2.5%.

2 MONETARY POLICY

Our scenario anticipates that the Fed should delay its first rate cut until December, whereas the first European rate cut could potentially come in June.

3 FIXED INCOME

We are reinforcing our positioning on high yield from 3 to 4, with a focus on carry as the primary driver of performance within the asset class.

4 EQUITIES

We remain confident that the market rally will continue to broaden in terms of sectors and regions.

The opinions expressed in this document are as at 6 May 2024 and are subject to change without notice.

Macroeconomic environment

Inflation: services resist

GLOBAL GROWTH'S STRENGTHS AND WEAKNESSES

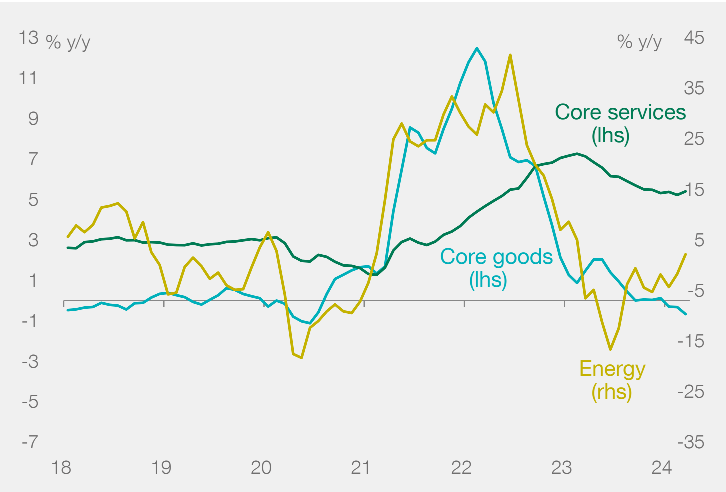
Global growth remains on a sustained trend of 3.0% for 2024. However, disparities between countries remain wide and geopolitical risks are high.

The US growth rate for the first quarter came in at 1.6%, marking a significant slowdown in comparison with the previous quarter's 3.4%. However, domestic demand remained strong at 3.1%, supported by consumption, which benefited from still-high job creation. At the same time, investment in new technologies is high and confidence has returned to the manufacturing sector. Growth should remain close to 2.5% this year, similar to 2023.

Growth in other developed countries is weak, but several indicators have picked up and point to a recovery in the second half of the year, for example, the UK is emerging from recession. In Germany, confidence in industry has finally recovered and its gross domestic product (GDP) was back in positive territory in the first quarter (+0.2%) after a previous contraction of -0.5%.

In China, sustained growth in the first quarter (5.3% y/y) was made possible by measures taken at the end of the year and the rebound in demand during the New Year. However, activity remained soft this past month and the Politburo decided to prepare new supports in favour of consumption, real estate and equipment upgrades via a looser fiscal and monetary policy.

US INFLATION (MAJOR SECTORS)



Sources: Fed, BLS, UBP
Past performance is not a guide to current or future results. Any forecast, projection or target, where provided, is indicative only and is not guaranteed in any way.

DISINFLATION: STILL ON THE MARCH, BUT SLOWLY

Global inflation has declined since its peak of 8.0% over the third quarter of 2022 but is slow to fall below 3.0%. We will have to wait until 2025 to see it return to around 2.5%, due to US inflation, which remains above 3.0%

and it will continue to fluctuate between 3.0% and 3.5% next quarter. In the United States, strong demand and services are responsible for this resilience. Indeed, rent, transport, repairs, insurance, and medical services have all seen price increases in the past months.

In Europe, services are holding up well, but disinflation remains the overall trend. Moreover, rents are weighing less on the indexes, and real estate remains depressed. Inflation is therefore likely to fall faster than in the United States, returning to around 2–2.5% over the next few quarters.

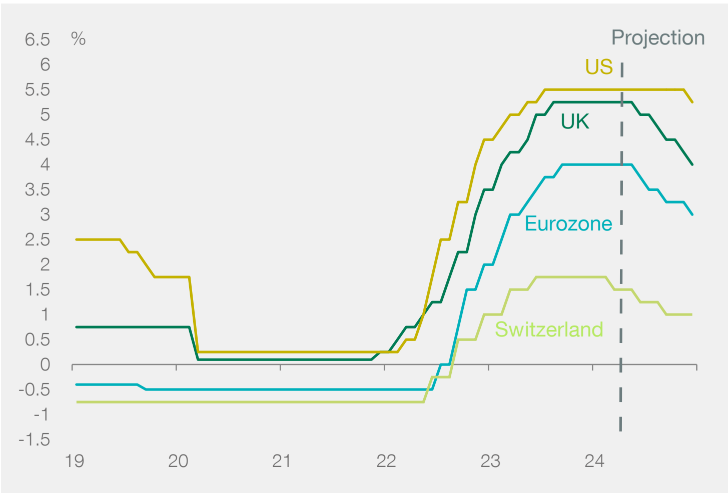
European Central Bank and Bank of England vs. the Fed: a possible decoupling

DECOUPLING OF RATE CUTS BETWEEN EUROPEAN CENTRAL BANKS AND THE FED

According to our inflation scenario, the Fed should postpone its first rate cut until December. We could see just one rate cut in 2024, but there is a possibility of no rate cuts at all this year if inflation continues to disappoint. In contrast, if employment unexpectedly deteriorates, the Fed could adapt its rate strategy sooner in order to fulfil its dual mandate, namely full employment and inflation control.

European central banks have more room to manoeuvre than the Fed in terms of disinflation. The first rate cuts could therefore begin in June, with the aim of reducing rates by 75 basis points in the eurozone and the UK, or even more if wages moderate further.

MONETARY POLICY PROJECTION OF MAJOR KEY RATES



Sources: Bloomberg Financial L.P., central bank, UBP
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A FRAGILE GLOBAL CYCLE EXPOSED TO RISKS

The current cycle remains heavily dependent on US activity. The gap with the rest of the world should gradually close, but other countries are not yet able to take the lead. The many conflicts and tensions over commodities could weaken their recovery, and oil prices above USD 100 per barrel would be a negative shock for Europe and energy-importing Asian countries. Global growth would then stagnate and inflation would pick up, forcing central banks to postpone or cancel interest rate cuts. The consolidation of the recovery in countries outside the US and China is a prerequisite for the sustainability of the current cycle.

Strategy

LOOK FOR A NEAR-TERM PEAK IN YIELDS GOING INTO SUMMER

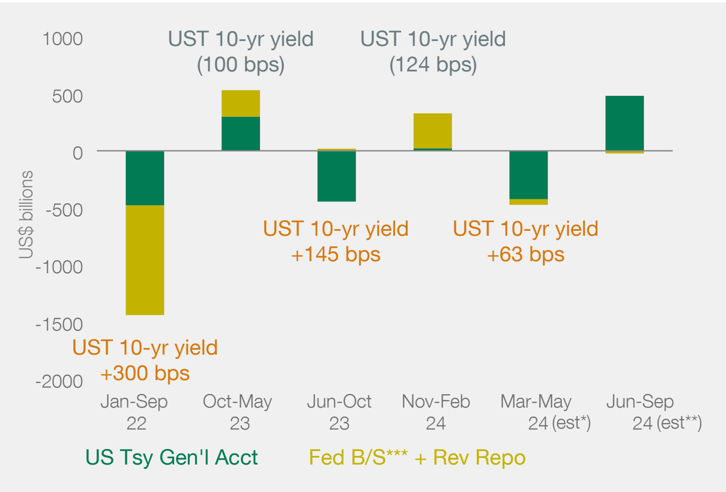
April saw further active conflict in the Middle East, raising inflationary concerns, weak US Treasury auctions, and a nearly USD 500 billion liquidity drain, leading to a surge in US Treasury yields and a nearly 5% sell-off in US and global equities, a near repeat of the backdrop that challenged investors in October 2023.

A pivot in global liquidity suggests a near-term peak in yields entering the summer

Fortunately for investors, as in October 2023, a series of catalysts are set to emerge going into the summer that should reverse these headwinds as anticipated in our April report.

Starting on 1 May 2024, investors can look forward to the Federal Reserve announcing a "tapering" of the pace of its balance sheet reduction begun in 2022. As outlined in the March 2024 Fed minutes, the US central bank should begin reinvesting as much as an additional USD 30 billion per month in US Treasury securities, or as much as USD 180 billion in incremental liquidity through to year-end as this tapering is implemented.

THE COMING LIQUIDITY INFLECTION GOING INTO SUMMER SHOULD ALLOW YIELDS TO PEAK IN MAY/JUNE.



Sources: Bloomberg Financial L.P. and UBP.
*Assuming BTFP wind-down and average tax collections.
**Assuming full drawdown of the reverse repo facility and normalisation of the US Treasury General Account.
***Fed B/S change net of TGA.
Note: 10-year yield change = peak-to-trough changes

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This comes as the seasonal liquidity drain associated with the American tax season in April fades and the USD 100 billion liquidity drawdown associated with the winding up of the emergency Silicon Valley Bank facility reaches its completion in May and June.

Looking back to 2022, these swings in liquidity have been instrumental in driving medium-term moves in both equity and bond markets.

10-year US Treasury yields should peak in the coming weeks and converge back towards 4.5%

Expanding liquidity profiles, which we anticipate to begin in June, have – as in October 2022 to May 2023 and November 2023 to February 2024 – coincided with both strong returns in global equities and falling US Treasury yields.

Therefore, assuming geopolitical tensions once again stabilise as they did in November 2023, this pivoting liquidity regime should mean the year-to-date rise in 10-year US Treasury yields should peak in the coming weeks and converge back towards our 4.5% target established in November 2023 in our 2024 Investment Outlook entitled, “Back to the Future”.

For global equity investors, this should offer a window of opportunity, as earnings momentum outside of global technology begins to re-accelerate moving through the summer, broadening the sectoral and geographic participation in the equity market rally year-to-date.

Asset allocation

1

Both bonds and equities delivered negative returns in April of -2.5% and -3.0% respectively

2

Value and European equities emerged as dominant styles and regions amid the prevailing narrative of prolonged higher rates

3

Elevated valuations in high yield are justified by our optimistic economic growth outlook

CHANGES TO OUR FIXED-INCOME POSITIONING

In April, the US economy sustained its robust growth trajectory, albeit with some signs of deceleration. Concurrently, persistent price pressures solidified the expectation of prolonged higher rates. Against this backdrop, both bonds and equities delivered negative returns of -2.5% and -3.0%, respectively, influencing year-to-date performance metrics for traditional portfolios. Notably, hedge funds and gold outperformed, registering returns of -0.5% and 3.9%, respectively.

With the trend of disinflation having been challenged for three consecutive months in the US, we adapted our asset allocation scenarios accordingly. From an initial market projection of six rate cuts at the start of the year, UBP anticipates a scenario of only one cut in December. This adjustment notably impacts our perspectives on fixed income, while corroborating recent modifications to our equity allocation.

In fixed income, our earlier anticipation of capital gains for 2024 has been revised, with the focus now mainly on carry as the primary performance driver within this asset class. Consequently, we are reinforcing our carry strategies by heightening our directional views on high yield from 3 to 4. Elevated valuations in this asset class are justified by our optimistic economic growth outlook, implying prolonged expensive conditions.

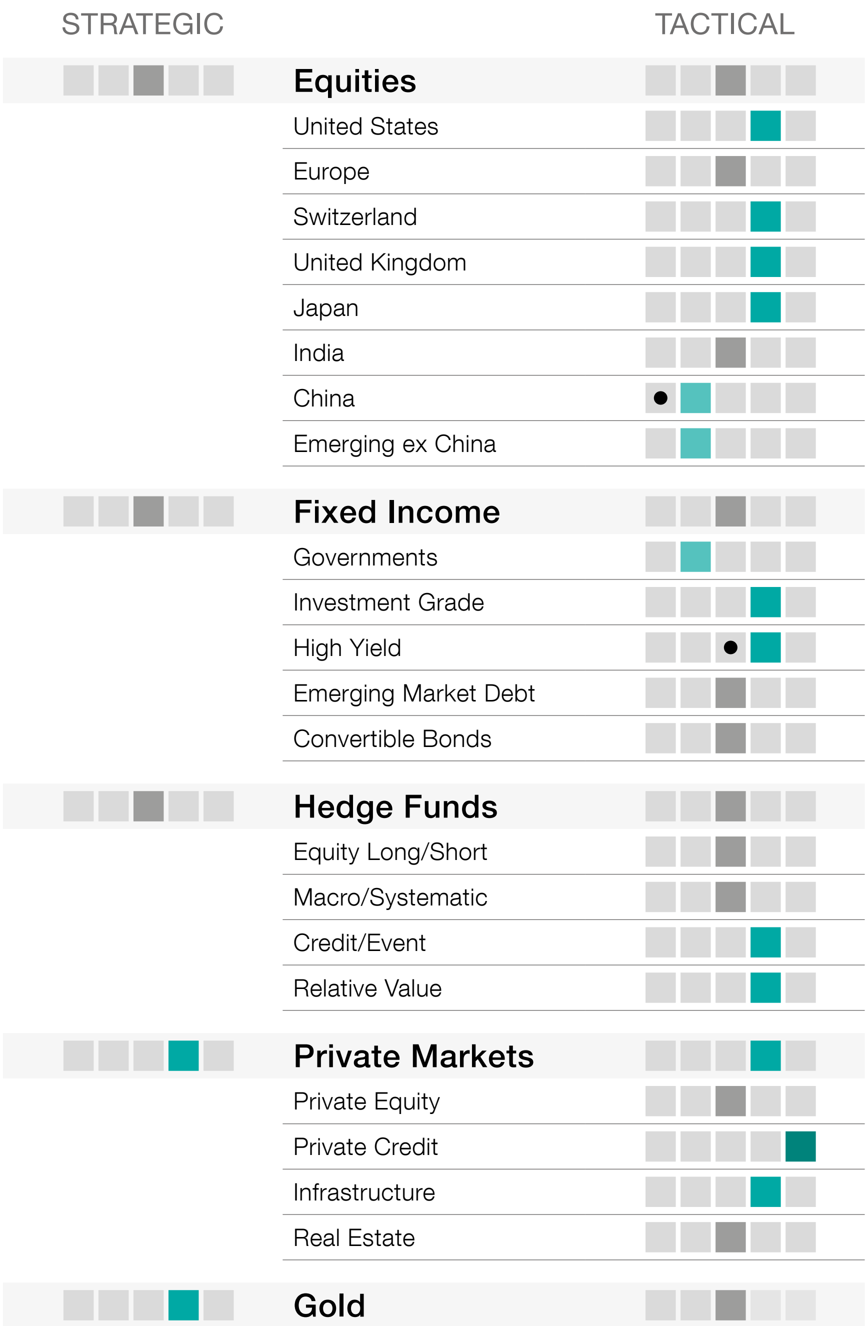
Regarding equities, we did not change the portfolio allocations following the significant movements in previous months, including the rises in UK and Swiss equities. Notably, value and European equities emerged as dominant styles and regions globally in April amid the prevailing narrative of prolonged higher rates. We remain confident in our belief that the market rally will continue to broaden in terms of sectors and regions.

Directional views

LOW CONVICTION | BASE LINE ALLOCATION | HIGH CONVICTION

PREVIOUS VIEW ● (no dot means no change)

Strategic (long-term view) and tactical (1–6 month) on broad asset classes, May 2024



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Asset classes

EQUITIES

NO SIGNIFICANT CHANGE IN POSITIONING

After a remarkable five-month rally since October 2023, global equities experienced a correction in April, resulting in a 3.3% dip in the MSCI World index, primarily attributed to the prevailing expectation of higher interest rates for longer. Despite this seasonal adjustment, which could persist into May, the prospects for equities remain positive for year-end.

The earnings season for the first quarter in both Europe and the US kicked off on a positive note, with earnings up by 7.0% for the S&P 500 so far (against 5.1% expected at the end of Q1), mostly driven by large-cap technology companies that delivered record earnings growth of approximately 35.0% year-on-year. Other sectors continued to struggle with negative average earnings growth for the first quarter, but this trend is expected to reverse in the upcoming quarters, justifying a projection for a broadening of sector participation.

These developments validate our strategic choice to diversify geographically and across sectors. While we enhanced and diversified our regional presence in the first quarter by entering the Indian market and bolstering investments in UK and Swiss equities, our equity positioning remained steady throughout April. Additionally, we decided to reduce our negative tactical stance on Chinese equities, upgrading their rating from 1 to 2. This is based on an expected cyclical tailwind for the Chinese economy in the short term, as well as potential long-term reforms that could be announced during the Chinese plenum over the summer.

FIXED INCOME

SHIFTING THE MINDSET TO CARRY

Anticipating the Federal Reserve deferring any rate cut until the end of the year, we view this as a signal of a prolonged period of elevated rates. Against the backdrop of constrained potential for spread compression, coupled with a favourable macroeconomic outlook, returns within the fixed-income realm are poised to derive essentially from carry. It is worth noting that current fixed-income markets offer historically high absolute yields, with levels rarely surpassed over the past two decades (excluding crisis periods such as the global financial crisis and the Covid pandemic). With this evolving narrative on rates, our strategic focus has shifted towards extracting carry within the asset class. Consequently, we have initiated a realignment of our high-yield allocation, transitioning away from short-dated securities towards intermediate maturities boasting superior yields, thus upgrading our tactical outlook. Any market setbacks are viewed opportunistically, presenting occasions to reinforce this strategic adjustment.

CONVERTIBLES

NAVIGATING VOLATILITY

As yields rose, spreads widened and equities dropped. With small- and mid-caps underperforming in April, the environment was unhelpful for convertible bonds. These moves were mainly triggered by stickier inflation and rate cut expectations being pushed back. Nonetheless, the asset class managed to offer some protection compared with their underlying equities, especially in the US, with a monthly performance of -3.6% vs. -6.9%, proving their downside protection benefits despite the unfavourable context. After strong months in February and March, the primary market cooled in April, a historically quiet month marked by typical seasonality trends. This timeframe is considered to be a blackout period coinciding with the start of the Q1 earnings season.

CURRENCIES

US DOLLAR ENTERS THE SUMMER IN GOOD SHAPE

Coming into May, the USD is in good shape. It has benefitted from robust labour market data and firm underlying inflation, suggesting that the Fed will be in no rush to cut rates. Front-end rate spreads have moved in the USD's favour, resulting in the USD/CHF trading at levels of above 0.91 and the EUR/USD trading towards 1.07.

The USD/JPY briefly rose to levels of around 160 following the Bank of Japan's April meeting, at which it maintained rates at 0%, however, it did reduce its 2025 inflation forecast. The JPY will remain on the weak side until US long-end yields stabilise.

HEDGE FUNDS

DISPERSION REMAINS A KEY DRIVER FOR RETURNS

Despite increased volatility of late, performances have held up well across the hedge fund industry and year-to-date performances remain largely on the positive side. Managers in both credit and equities continue to benefit from increased dispersion as both inflation and rate expectations remain challenged.

Overall, the positioning has not materially changed among quantitative macro managers, with a high level of increased directionality on several markets, and we remain cautious in the short term for this strategy. Indeed, with such a positioning, the potential protection they generally provide in a correction could be challenged. Overall, we continue to favour managers with low net exposures and balanced portfolios that are well placed to benefit from dispersion and idiosyncratic opportunities across a wide range of markets.

PRIVATE MARKETS

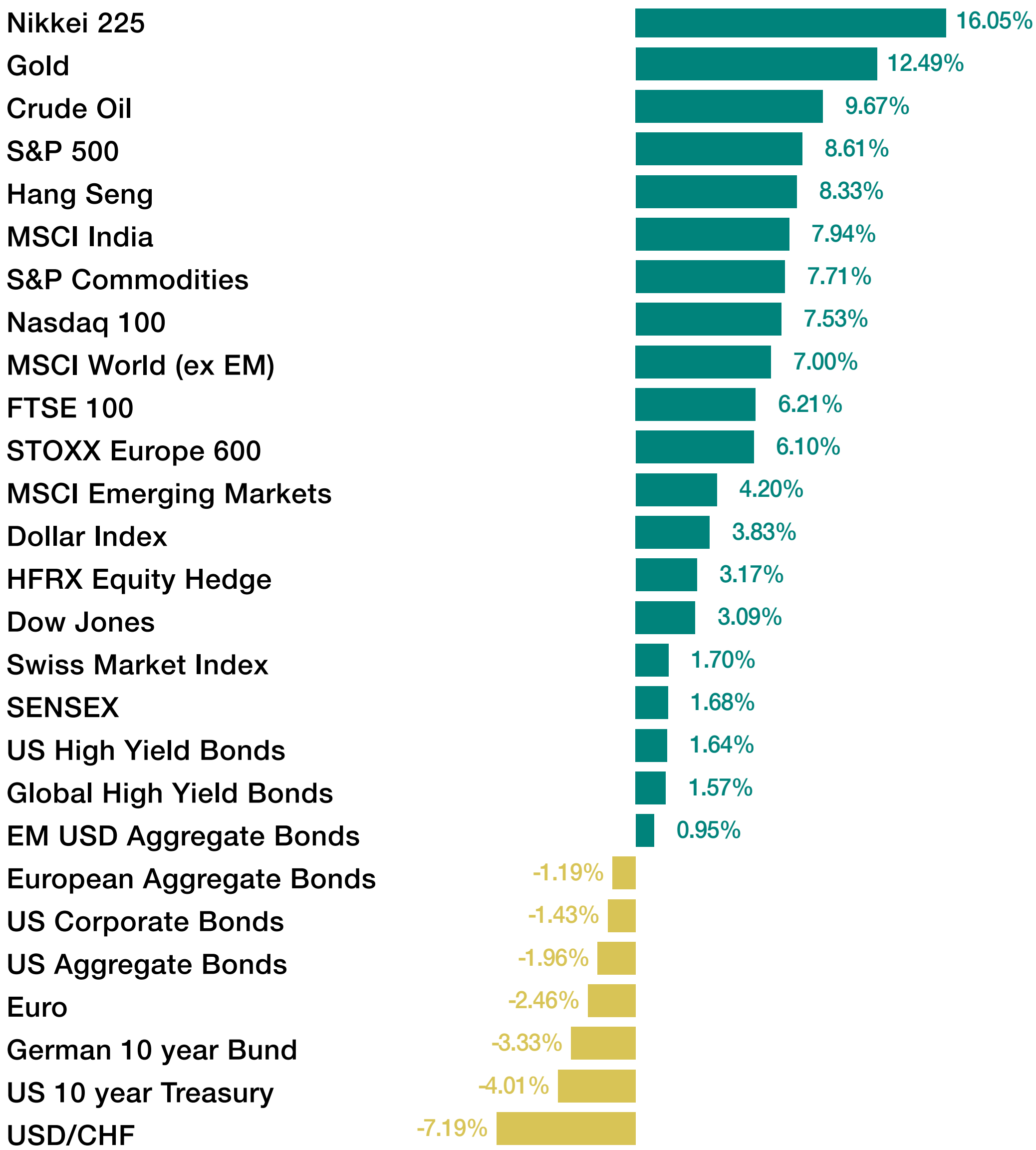
PRIVATE CREDIT IS EVOLVING AND A FORGOTTEN PLAYER IS COMING BACK

Private credit has been the darling of private markets' strategies over the past decade. The banks' disintermediation trade that started after the global financial crisis following the regulatory push to shore up deposits from risky operations has emerged as the biggest force behind the advent of non-bank lending. Add to this the convergence of developed economies' zero-interest-rate policies and the perfect recipe for a booming private credit was put together.

However, some elements may start to leave a bitter taste. As rates are getting anchored at much higher levels, the asset class has started to see a significant slowdown in fundraising as alternatives emerge as reasonable contenders. Also – and this will be closely monitored – banks are starting to compete head-to-head with direct lenders on some large transactions as they are trying to regain market share. Until today, when banks and direct lenders were issuing terms on a loan, the banks were always more competitive on headline margins. Last, the largest direct lenders are now moving toward the less risky part of the market by addressing the financing needs of low-risk borrowers. The reasons behind this are twofold: on the one hand, financing needs globally are increasing, especially in the infrastructure space where demand exceeds what banks are willing or able to issue; on the other hand, some large direct lenders are also operators of insurance businesses, such as fixed-annuities insurance. This type of activity is a classic asset/liability management business which is particularly well suited for investment-grade-like credit risk, hence the push from direct lenders in this sub-corner of the credit market.

Market performances

2024 YEAR-TO-DATE RETURNS (%), DATA AS AT 6 MAY 2024



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