Markets once again fully reassured by Fed

September 2nd, 2024

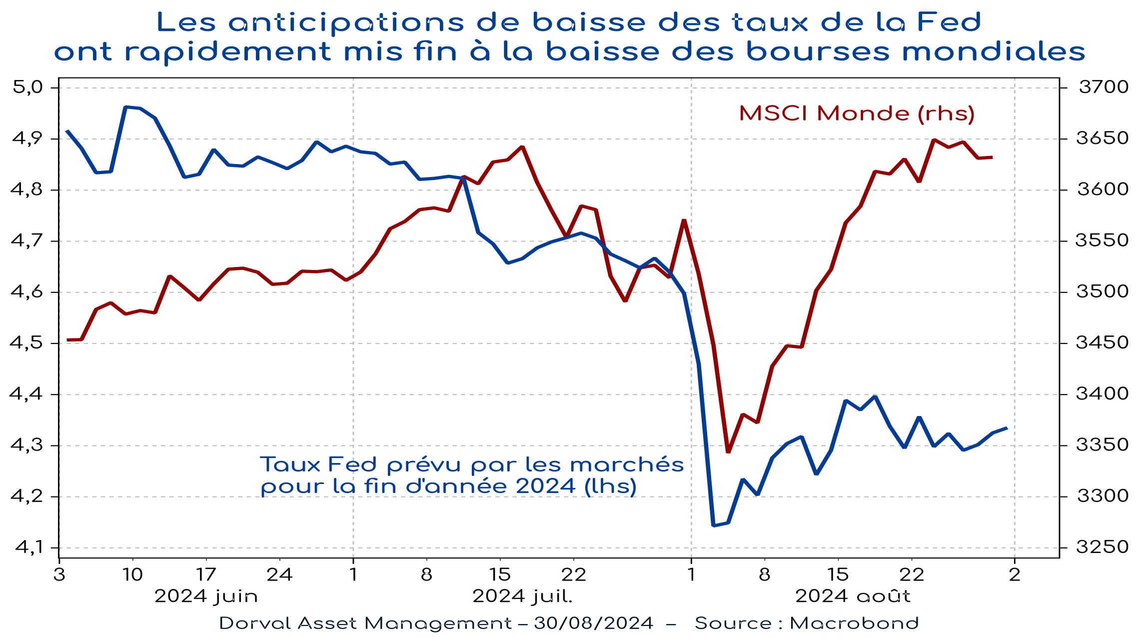
Dear Clients and Partners,

August will show that, just as investors were starting to worry, the Federal Reserve has fully regained its ability to reassure them, thanks to a slowdown in inflation. It remains to be seen whether growth prospects will improve outside the United States, particularly in Europe, where skepticism is returning with a vengeance.

Equity markets had recovered sharply between October 2023 and May 2024, boosted by lower inflation in the US, the Ukraine shock having been absorbed and the stability of global growth. Share prices were also higher thanks to microeconomic factors such as the AI boom and a sharp rise in the profits of financial companies.

From June onwards, investors' strong, perhaps excessive, optimism was undermined first by the elections in France, then by the threat of the US economy slowing more than expected and finally by the collapse of speculative yen positions. AI-related stocks being overbought also played a part. The sell-off was complete within three trading days at the very beginning of August, with implicit volatility as measured by VIX reaching 65% on the fifth of the month, its highest level since the Covid crisis. However, the MSCI World lost only 9% from its mid-July high to its low point on 5 August before starting to climb again (cf. chart 1).

Expectations of a Fed rate cut quickly ended the global stock market decline



MSCI World (rhs)

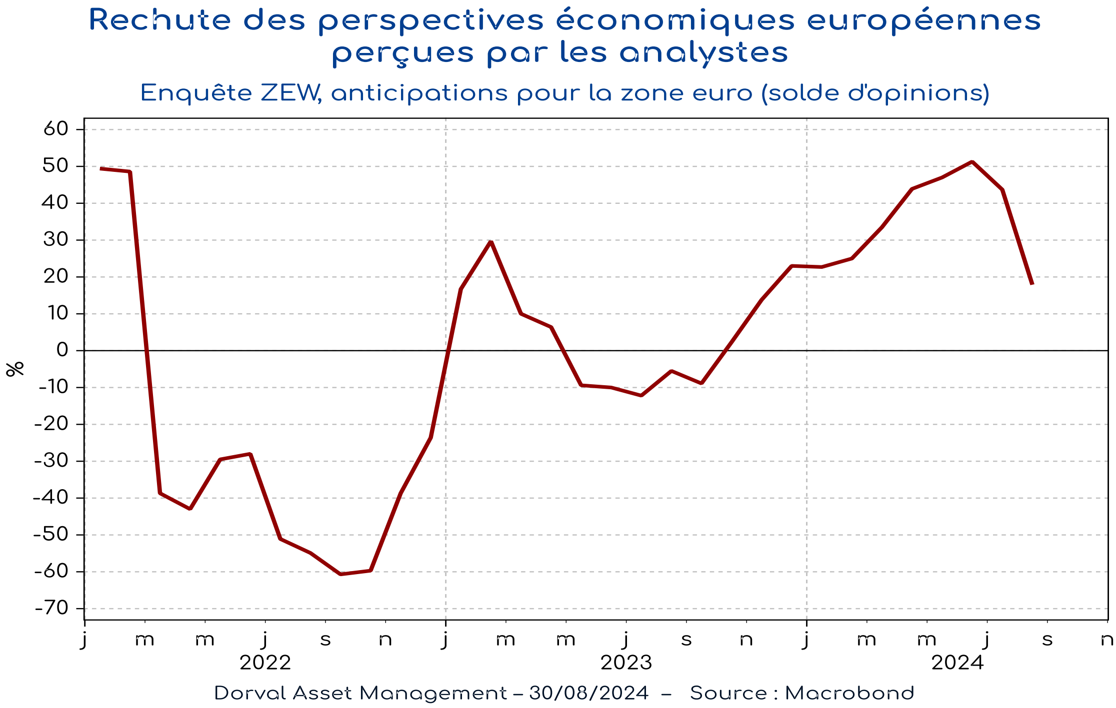
Fed rate forecasted by the markets for the end of 2024 (lhs)

This relative panic prompted US long-term yields to plummet, from 4.25% to 3.80% in just a few days, a self-stabilising drop for global markets, which were beginning to anticipate central bank intervention. Indeed, at the annual Jackson Hole Economic Symposium, Jerome Powell strongly hinted that the Fed would cut interest rates on 18 September to mitigate the risks of the labour market's currently modest weakening becoming more severe. The Fed Chair stressed that they still had ample room to respond should any problems arise, although he believes that there will be no need for quick and decisive action as he remains optimistic about the US economy. With this in mind, investors will pay close attention to the next US Employment Situation Summary, scheduled for publication on 6 September. Having said that, Powell's speech could not have better illustrated the notion of the Fed's protective put.

Growth prospects outside the United States now need to be consolidated. This is particularly important for Europe, where a degree of skepticism is being fueled by a crisis in German industry and political problems in France. After several months of clear growth, there has been a sharp downturn in analysts' forecasts for the eurozone economy since June (cf. chart 2).

Decline in analysts' outlook for the European economy

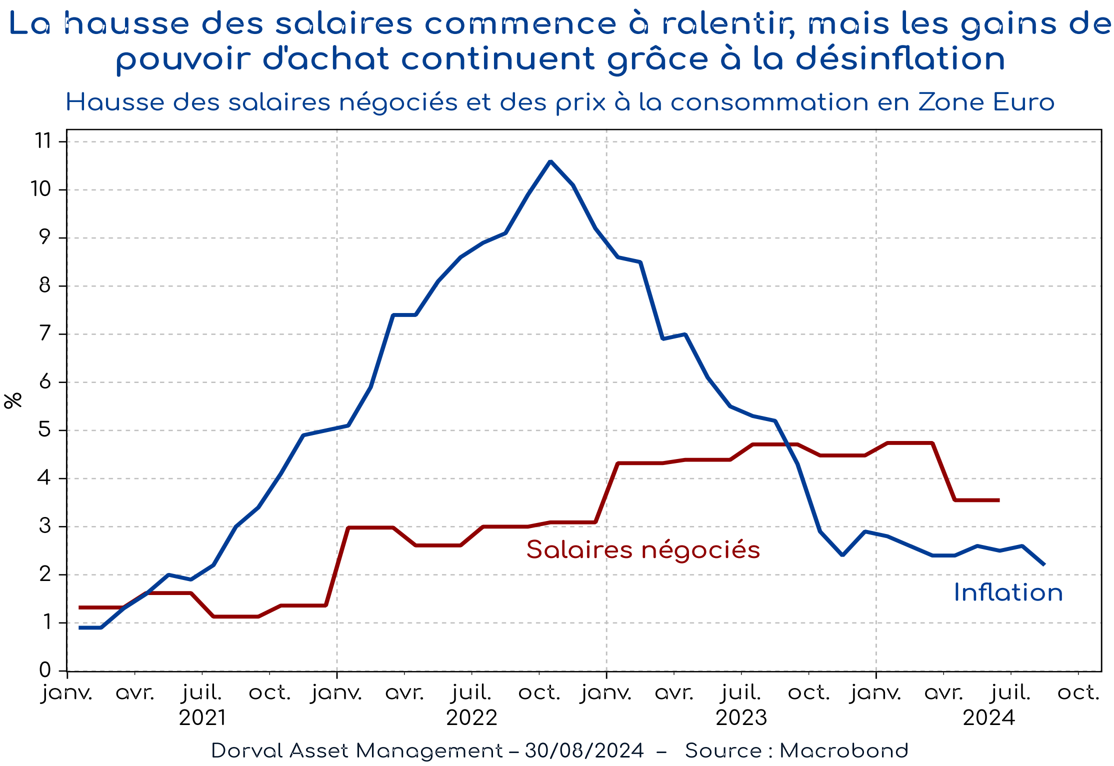
ZEW survey, eurozone forecasts (balance of opinions)



The pessimism surrounding the economic situation in the eurozone is probably a little exaggerated, particularly with unemployment reaching its lowest level in decades in July at 6.4%. It is true, though, that there are significant barriers to growth in Europe. Despite its economic difficulties and considerable room for maneuver, Germany still refuses scrap its balanced budget rule. France, meanwhile, is waiting for a new government to be formed. However, the fall of inflation to its three-year low of 2.2% in the eurozone should support the economy in two important ways. The first is purchasing power, which has been rising very steadily for about a year as prices have increased less quickly than wages (cf. chart 3). The second is falling money market and bond rates, a trend that is already starting to trigger demand for property loans in some countries (such as France, as reported by the banks). The ECB will naturally remain cautious in the short term because core inflation, i.e. excluding food and energy prices, remains a little high, particularly in services. Having said that, it should be able to lower its rates by at least a further 25 basis points on 12 September.

Wage increases are starting to tail off, but purchasing power continues to rise thanks to a slowdown in inflation.

Rise of negotiated wages and consumer prices in the eurozone



Negotiated wages

Inflation

When managing our European and global flexible funds, we took advantage of the early August dip to strengthen our equity market positions. In our global funds, we also added some Japanese banks that had experienced sharp falls. These banks complement our initially European basket of financial stocks. Lastly, despite central banks cutting interest rates, we are staying away from the bond markets for the time being given that they have already priced in significant rate cuts in the coming quarters.

Our exposure rates are as follows:

- Dorval Convictions: 72% net exposure to equities, comprising 60% Euro STOXX 50 SRI core basket, 6.5% financials basket, 12% small caps basket. Hedged using Euro STOXX 50 futures and options.

All of us at Dorval Asset Management hope you had a great summer and wish you a successful start to the autumn.

Dorval Asset Management

Public limited company with share capital of €493,876

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