## WEEKLY VIEW: 2 OCTOBER 2023

# RISING ANXIETY

## SUMMARY


– Congress dodges shutdown, but uncertainty reigns
– Bond vigilantes punish higher Italian deficit projections
– BOJ's Ueda says "still a distance to go" before ultraloose policy exit


## Victory for Europe

César Pérez Ruiz
Chief Investment Officer

Congress's vote on Sunday to avoid a US government shutdown averted an immediate crisis but not economic and financial uncertainty. Heightening concerns for markets, the Speaker of the House of Representatives, Kevin McCarthy, faces a possible vote on his leadership for brokering the deal. The tense talks in Washington played out against an equally fractious Ryder Cup, won by Europe. Highlighting markets' nervousness, the VIX Index of volatility hit its highest level since May last week. Market jitters saw the 10-year Treasury yields rise in September from 4.1% to 4.57%, increasing competition for stocks, as Federal Reserve officials talked about rates staying higher for longer. Thus, the S&P500 lost 4.8%[1] (in USD) in September, the Nasdaq dropped 5.8%[2] (in USD) and small caps even more. **We are underweight small caps, which are more sensitive to rates than larger caps as they have a higher share of floating debt.** Treasury yields, near multi-year highs, eased slightly on Friday on news that the core PCE price index, the Fed's preferred inflation gauge, eased to 3.9% on a yearly basis in August from 4.3% in July. However, updated second-quarter GDP data showed a sharp downward revision to consumer spending. Near-term risks point to lower growth and possibly higher inflation, meaning **the Fed is likely to proceed carefully and retain a hawkish bias.**

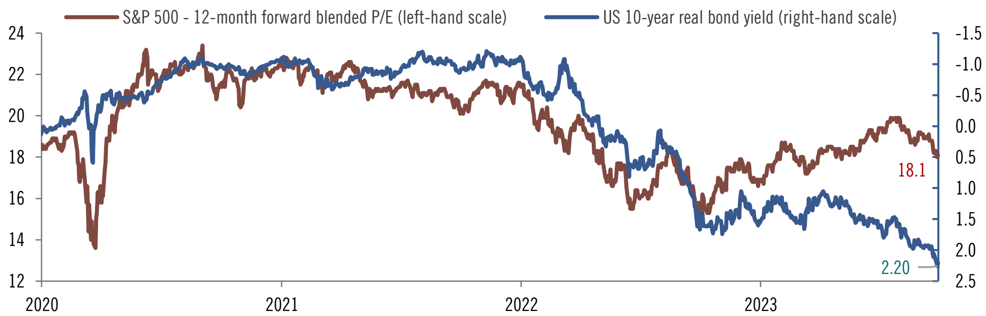
In Italy, bond vigilantes showed they are back and ready to impose discipline on policymakers through higher yields. Italian 10-year yields rose to 4.95% during the week before closing at 4.78% as the Italian government lifted its 2023 and 2024 deficit projections. UK 10-year yields jumped too, with high oil prices fanning concerns in bond markets that persistent inflation could keep rates higher for longer. **We maintain our Brent year-end target of USD95 per barrel.** Euro area headline inflation eased to 4.3% in September from 5.2% in August. In bad news for growth, euro area economic sentiment fell for a fifth consecutive month in September. **We expect the ECB to keep rates on hold.**

In Japan, the finance minister said the country won't rule out any options to deal with excessive currency volatility, reiterating a warning against speculative moves on the yen. Bank of Japan (BoJ) Governor Kazuo Ueda said considerations over the central bank's finances would not prevent it from phasing out its monetary stimulus when the appropriate time comes, adding that there was "still a distance to go" before the BOJ exits its ultraloose monetary policy. The Nikkei ended last week at a one-month low and the 10-year government bond yield hit a 10-year high before closing at 0.765%. **While the BoJ is likely to normalise its monetary policy, the pace of normalisation could be very slow in an environment in which the inflation outlook is still highly uncertain.**

## CHART OF THE WEEK: HIGHER BOND YIELDS START TO HURT

Recent central bank announcements have led the market to believe that rates could remain structurally higher than in the past, with the US 10-year real Treasury yield rising 32 bps in September. Price-earnings (P/E) ratios for US equities managed to resist rising bond yields for some time, remaining elevated. But equity valuations have started to feel the pain as concerns about corporate profitability in the face of increasing refinancing costs impact investors' risk appetite. Indeed, the market's previous bullish pricing of the 12-month forward P/E is going into reverse, mirroring the sharp upturn in sovereign yields.

**"Higher for longer" hits the earnings multiple**




*Source: Pictet Wealth Management, Bloomberg Finance L.P., as of 28.09.2023*

## MACROECONOMY: INFLATION DOWN, BUT NOT OUT

**Mixed news for US economy**

US durable goods orders rose by 0.2% in August on the previous month. The figure exceeded expectations of a decline, with core capital goods orders rising 0.9%. On a more downbeat note, existing home sales in August declined by 15.3% from a year earlier. The Fed's preferred price measure, the core personal consumption expenditure (PCE) index, rose at an annual rate of 3.9% in August. Although the latest figure is down from 4.3% the previous month, core PCE is still almost twice the Fed's official inflation target.

**Euro inflation heads down**

Consumer prices in the euro area rose at an annual rate of 4.3% in September, down from 5.2% in August, to hit the lowest rate in almost two years. Core inflation (excluding food and energy) rose by 4.5% last month compared with 5.3% in August. There was an especially big drop in German consumer price inflation, which went down to 4.5% in September from 6.1% the previous month.

**Tokyo inflation down, Japanese manufacturing sentiment up**

The consumer price index for the Tokyo region (seen as a precursor for Japanese inflation) eased to a year-on-year rate of 2.8% in September from 2.9% in August. There was a sharper fall in core CPI, to 2.5% from 2.8%. Retail sales in Japan grew more than expected in August while the Bank of Japan's latest Tankan survey of big manufacturers' confidence rose strongly in Q3 (to 9 from 5 in Q2).

## MARKETS: FRAZZLED

**Equities suffer from bond competition**

Last week was characteristic of much of September, with US stocks hurt by the realisation that policy rates were going to stay high for a while and that rate cuts were not around the corner. The resultant rise in bond yields hurt growth and tech stocks in particular, while US small-cap indexes continued to wilt, hurt hard by tightening financial conditions. Overall, the S&P 500 dropped 4.8%[3] in September (in USD). While valuations have been falling, and we could see a short-term rebound, the competition from Treasury yields means we remain underweight US equities. Meanwhile, a further rise in oil prices, together with continued US dollar strength hurt EM stocks. While euro area stocks received a late-week fillip from the drop in inflation to a two-year low, September was also a difficult month for the Stoxx Euro 600[4] with wide discrepancy between the best-performing stocks and the worst-performing ones. On the earnings side, we expect profits for S&P 500 to come in about flat in Q3. We also believe that analysts' earnings forecasts for next year somewhat optimistic as the US economy slows. But it is increasingly difficult to spot any clear economic or market trend, this is a time for stock-pickers.

**Bonds hurt by 'higher for longer' mantra**

The 10-year US Treasury yield hit its highest level since 2007 at one stage last week as the 'higher-for-longer' mantra caught hold, and over September as a whole rose 48 bps to end the month at 4.57%. News of falling inflation on both sides of the Atlantic helped calm bond markets at the end of last week, but this was offset by worries about renewed inflation stemming from oil prices. And in Europe, the announcement of increased government borrowing led to spread on Italian bonds widening to above 200 bps over German Bunds at one stage. With the French government also revising higher its budget deficit forecast, there was a sell-off in euro area bonds in general. The recent rebound in UK gilts also went into reverse last week on worries over oil prices and enduringly high interest rates. Spreads on noninvestment-grade bonds rose significantly last week, with significant tightening of financial conditions to be seen in a 10-year US high-yield rate that reached almost 9% last week. Overall, despite legitimate reasons to be concerned about long-run inflationary pressure—and the impact of another federal shutdown on the US's credit standing—higher rates should be expected to slow the US economy and increase competition for US equities.

**The dollar benefits from higher yields**

The US dollar's strong run continued last week, in line with the rise in US bond yields. The euro felt the brunt of dollar strength because a fall in euro area inflation rate made further rises in the ECB's deposit rate more unlikely. The cliff-edge negotiations around raising the federal spending limit could have dented the greenback's popularity, but instead the currency's 'safe haven' status came to the fore. High interest rates also weighed heavily on the gold price and, to a lesser extent, on the Japanese yen. The latter fell close to levels at which the Japanese authorities intervened last year. Indeed, the Ministry of Finance hinted at renewed interventions to curb yen's weakness. Our view remains that high US interest rates could go into reverse as US economic activity slows, meaning trends could turn less negative for both the yen and gold.

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[1] Source: Pictet WM AA&MR, Thomson Reuters. Past performance, S&P 500 Composite (net 12-month return in USD): 2018, -4.38%; 2019, 31.5%; 2020, 18.4%; 2021, 28.7%; 2022, -18.1%.
[2] Source: Pictet WM AA&MR, Thomson Reuters. Past performance, Nasdaq Composite (net 12-month return in USD): 2018, -2.8%; 2019, 36.7%; 2020, 44.9%; 2021, 22.2%; 2022, -32.5%.
[3] Source: Pictet WM AA&MR, Thomson Reuters. Past performance, S&P 500 Composite (net 12-month return in USD): 2018, -4.38%; 2019, 31.5%; 2020, 18.4%; 2021, 28.7%; 2022, -18.1%.
[4] Source: Pictet WM AA&MR, Thomson Reuters. Past performance, STOXX Europe 600 (net 12-month return in EUR): 2018, -10.2%; 2019, 27.6%; 2020, -1.5%; 2021, 25.5%; 2022, -10.1%.

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