WEEKLY VIEW: 25 SEPTEMBER 2023

IS THIS IT?

SUMMARY

– **Fed opts for hawkish pause; eyes on inflation data**
– **Markets watching for potential US government shutdown**
– **Geopolitical tensions hit tight oil market**

Connecting the dots

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Markets will be on tenterhooks this week for the release of the Federal Reserve's preferred inflation measure, core PCE, on Friday for indications as to whether the Fed has finished hiking interest rates. Another driver for markets is the risk of a government shutdown, with US lawmakers saying time is running out for a deal to resolve a budgetary impasse. Last week, the Fed left interest rates unchanged but surprised markets with a more hawkish "dot plot" for 2024. Members of the Federal Open Market Committee (FOMC) now expect rates to fall by 50 bps next year instead of 100 bps previously. That is consistent with our 'higher for longer' view. After the Fed's unexpectedly hawkish stance, the 10-year yield briefly hit 4.5% (the highest since 2007) before easing slightly. The Fed also revised up its 2023 growth projections from 1.0% to 2.1%, referencing the tight labour market. **In equities, we are underweight small caps, which are more sensitive to rates as they have a higher share of floating debt**. Small caps and the Nasdaq both lost more than 3% on the week. Cyclicals have stopped outperforming defensives as markets worry about the impact of higher rates for longer.

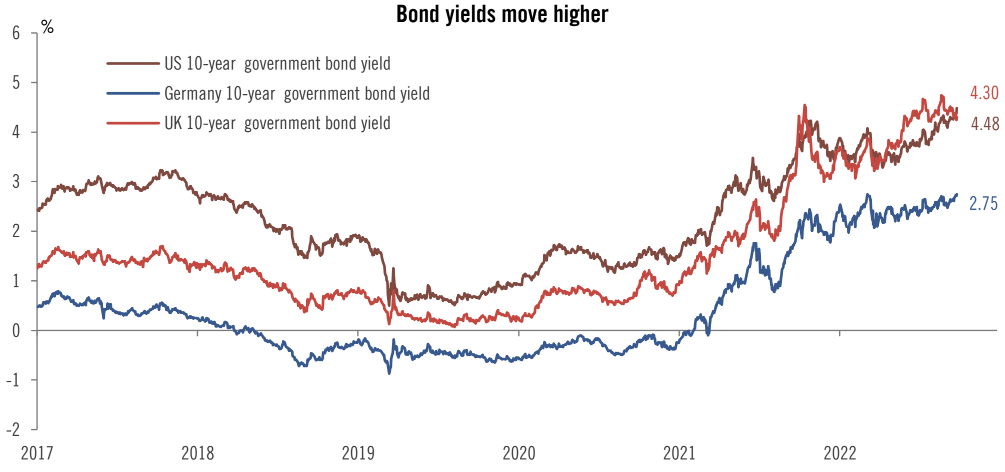
In Europe, the Bank of England left its policy rate unchanged at 5.25% but said policy would need to be "sufficiently restrictive for sufficiently long". It decided to accelerate its quantitative tightening. The Swiss National Bank kept its policy rate unchanged and said tightening over recent quarters is dampening inflation. The surprise SNB decision weakened the Swiss franc, which lost more than 1% versus the dollar. **We are negative the Swiss currency.** The Dutch parliament approved a proposal to raise taxes on banks, hitting shares in the country's largest lenders.

The dispute between Armenia and oil-rich Azerbaijan over the Nagorno-Karabakh region added to anxiety in the tight oil market last week. A ceasefire was brokered but the latest tensions are another example of geopolitics complicating the outlook for markets. Oil prices remain well supported by production cuts, including a reduction in Russian exports. **We maintain our $95 Brent year-end target.** In another example of the increasingly fraught geopolitical environment, a diplomatic dispute between India and Canada escalated. In Brazil, the central bank cut its policy rate by 50bps for the second time. Latin American countries led the Fed's hiking cycle by 12-18 months and the same is now happening on the easing front. **We are overweight EM bonds in local currency.**

CHART OF THE WEEK: RATES WILL STAY HIGHER FOR LONGER

Following the Federal Reserve's hawkishness last week, the US 10-year sovereign bond yield rose at one stage to 4.5%, its highest level since 2017. The yield increase was mainly driven by rising real rates due to a resilient US economy, as well as by the hawkish Fed, which showed itself relentless in taming inflation. By contrast, UK gilt yields fell last week as a dovish Bank of England showed concern about the lasting negative side-effects of high rates while remaining committed to keep rates "sufficiently restrictive for sufficiently long".

Bond yields move higher



Source: Pictet Wealth Management, FactSet, as of 22.09.2023

MACROECONOMY: SUBDUED

Euro business activity remains in the doldrums

S&P Global's purchasing manager index (PMI) showed that business activity contracted again in September, although the composite number improved to 47.1 from 46.7 in August. The manufacturing PMI, at 43.4, remained in the doldrums, while the services PMI rose to 48.4, a two-month high.

US economy keeps head above water

S&P Global's manufacturing PMI for the US improved to 48.9 this month from 47.9 in August, but remained in contraction territory. With the services PMI edging lower, the composite PMI was 50.1, down slightly from 50.2 in August. Existing home sales in the US declined by 0.7% in August from the month before and by 15.3% from a year before.

Mixed news for UK economy

Headline inflation in the UK fell to an annual rate of 6.7% in August from 6.8% in July. Core inflation (excluding food and energy) dropped more steeply, to 6.2% from 6.9%. In further good news, public borrowing came in below forecast in August, thanks to higher government receipts. But the preliminary PMI figures flashed recession, with a drop in services activity pulling the composite number down to 46.8 in September, its lowest level in 32 months.

MARKETS: SIGNS OF NERVES

Equities disturbed by Fed signalling

US equities did not like the hawkish tone adopted by the Fed last week, with the S&P 500 losing a hefty 2.9%[1] for the third straight week of losses (in USD). The shift downward in Fed officials' expectations for rate cuts seen next year, along with the option it retained to hike rates again this year, contributed to the negative mood. Fed officials raised their GDP forecasts, showing greater confidence that the US economy can withstand 'higher-for-longer' rates and that a 'soft landing' can be achieved. While our own view is that the US could suffer a mild recession, this thesis might seem justified by the September PMI numbers, which showed US business activity remaining above 50. But markets are nervous, especially as previous rate hikes permeate the economy through higher borrowing costs. The spike in bond yields that followed the Fed officials' new 'dot plots' dragged down growth-like and cyclical stocks in particular, with the Nasdaq down 3.6%[2] on the week (in USD). In the circumstances, scepticism about tech valuations continued to spread. Some indexes outside the US did better, including, in the UK, the multinational-heavy FTSE 100, down just 0.4%[3] (in GBP), and China's CSI 300 Index (up 0.4%[4] in USD), helped by some improving economic data. Overall, with markets having to come to terms with policy rates staying high for a while yet, risk management will be paramount.

Bonds get a bruising

US Treasury yields spiked higher following the hawkish noises from the Fed last week, with the 10-year Treasury yield briefly reaching 4.5%, its highest level since 2007. The more policy-sensitive two-year yields also punched higher and stood at 5.11% at the end of the week. Inflation-linked US Treasuries of above 3% for two-year maturities still look attractive to us. Among the most striking elements to emerge from the Fed meeting last week was the change in the famous 'dot plot', which showed Fed officials predicting a fed funds rate at 5.13% at the end of next year, higher than market participants' expectations and only 20 bps lower than today's level. This doused market hopes for a more vigorous rate-cutting campaign next year and led to the bond rout, which was also visible in Europe, where the 10-year German Bund rose to 2.74%, its highest level in 10 years. The approach of the 1 October deadline for agreeing on a new US federal funding plan is also keeping bond markets volatile. But it was not all bad news on sovereign bond markets, with a decline in UK and Swiss bond yields following decisions by the Bank of England and Swiss National Bank to leave interest rates unchanged.

The SNB brings the franc down

The Swiss franc and British pound dived against the euro last week in the aftermath of decisions by the Bank of England and Swiss National Bank (SNB) to leave policy rates unchanged, contrary to market expectations. The franc's strength just as concerns grow over Switzerland's economic outlook may have led to the SNB's less aggressive monetary stance. The Japanese yen also suffered from monetary policy stasis as well as somewhat dovish-leaning comments from Bank of Japan governor Kazuo Ueda. That said, there is an increasing sense that the Bank of Japan is getting more data-dependent, with the inflation outlook set to have a strong bearing on the yen. Although it too left rates unchanged, the Fed's hawkish guidance last week led the market to further delay its forecast for the first rate cut. The resultant rise in bond yields along with weakening global risk appetite proved a supportive environment for the high-yielding and safe-haven US dollar.

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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, FTSE 100 Index Total Return (net 12-month returns in GBP): 2018, -8.73%; 2019, 17.3%; 2020, -11.5%; 2021, 18.4%; 2022, 4.7%.
[4] Source: Pictet WM AA&MR, Thomson Reuters. Past performance, CSI 300 Index Total Return (net 12-month returns in USD): 2018, -27.6%; 2019, 37.2%; 2020, 38.4%; 2021, -1.0%; 2022, -26.5%.

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