APRICUS FINANCE

WEALTH MANAGEMENT

October 2023

Central Banks 'Higher For Longer', and Doubts about China's Economic Health, Hit Financial Markets

Both the European Central Bank and the US Federal Reserve paused rate hikes and commented that 'rates will have to stay higher for longer'. This sparked a sell-off in long-term government bonds, leading to marked curve flattening, particularly in the US. Doubts about the Chinese government being able to kick start its economy compounded the losses.

With yields rising quickly, stock markets got pulled sharply lower, particularly in the US – down 4.8% for the month - led by the 'Magnificent Seven', down 5.6%, and small capitalizations, such as the Russel 2000, losing 5.9%. The 'Magnificent Seven' actually recovered most of their losses during the first part of October. Europe outperformed: the STOXX 600 only lost 1.6%, helped by this year's laggard, the UK market, up 2.4%, and Switzerland, down by 1.3%. Even the Eurozone, with sickly Germany, outperformed the US: down 3%, helped by positive performances in energy, basic resources, and banks. Japan was another major market that showed a positive performance for the month, whether currency hedged or not.

The sell-off in September was very unusual in the sense that credit didn't really join in, particularly in the Eurozone: both High Yield and Hybrid bonds were positive for the month, investment grade corporates, while negative on the month, also outperformed, being down by only 0.9%: the Euro hedged Global Aggregate bond benchmark lost 1.9%.

Gold was caught up in the swirl of higher rates, and lost 4.7%, before recovering those losses almost entirely after the tragic and dramatic events in Israel.

Just before, and even after, the events in Israel, crude oil behaved curiously: dropping by 8%, or 7 USD, over two days before the events, and initially rising, before dropping, after the events over the weekend. It can probably be attributed to technical factors. The crack spread, (the difference), between US-listed gasoline and crude oil have recently been trading at an abnormal 40 USD, as many investors had piled into distillate contracts rather than crude oil. Likely triggered by data that shows that seasonal gasoline demand in the US had dropped to a 25-year low, the gasoline contract started to fall, breaking some key technical levels, and eventually dropping by 20%, taking the price of crude along with it. Eventually, the crack spread is now down to 8 USD, which is probably good news for car drivers in the US, and less good news for refiners. As fears over a regionalization of the conflict have increased over the last few days, distillates and crude oil have rebounded over 5%. However, gasoline at the pump is now 8% cheaper than in mid-September, and futures on unleaded gasoline are 14% off.

Higher For Longer: But Not Too Long

We believe that both central banks, the ECB and the Federal Reserve, are done on this hiking cycle. Of course, like often in the past, central banks can incur policy mistakes, and go one step too far: these mistakes usually get reversed quite quickly.

In the US we think that:

- The market has completed the job for the central bank.
- Real yields hit plus 2.4%, moving from minus 1% in spring 2022. The highest level since the Global Financial Crisis.
- Financial conditions tightened quite severely thanks to the back-up in long-term rates.
- Senior Loan Officer surveys indicate a strong contraction in credit demand from mid and small-sized businesses, which might struggle to survive with current high rates and the increased spreads over cost of funds that the banks are charging. The temperature of these surveys was taken in July, before longer rates started taking off.

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On a side note: while last month we expressed our skepticism towards surveys, this is one we believe delivers reliable results. The entity asking the questions is your regulator: first, you do answer the survey, and second, you are minded to give a reliable answer.

- With mortgage rates at close to 8%, coupled with high house prices, the dream of buying the first house for an entire generation is getting destroyed. It is thus unsurprising that the number of new mortgage applications fell to a level last seen in the nineties. The good news in the US is that, in contrast to the UK, most mortgages have a maturity of 30 years: current owners are unscathed by the high rates.
- US consumer excess savings are all but gone. Consumers are increasingly resorting to credit cards.
- Whilst outstanding debt on credit cards surpassed USD 1 trillion - as per the government, the average interest charged on credit cards surged to an historic high of 22.8%. According to independent research companies, that level is actually 24.5%. On top of that, you must add administration fees, late payment fees and so on. The effective rate charged is thus north of 30%.
- Therefore, in a presidential year, the lower-and middle-income classes are suffering. Delinquencies on credit cards and auto loans are rising. As the PayPal CEO commented: 'cracks are starting to show in consumer finances'.
- Student debt must be repaid again.
- However, unemployment is sufficiently contained that fear of unemployment is low —encouraging consumption. The US labor market and retail sales, among other economic indicators, still suggest a soft landing.
- Without delving into US politics, one observation on current strikes from United Auto Workers and others: for statisticians and central bankers, food prices at the supermarket have been stable since February of this year, meaning inflation is currently close to zero for that segment on a month-on-month basis. However, food prices are up close to 26% from pre-pandemic, while real wages have been crushed for years. It is thus not surprising that those workers are asking for 'exorbitant' salary increases of 30% or more.

We thus believe that:

- Conditions are now probably excessively restrictive in real terms.
- As inflation in the US is coming under control, real rates will go up. Therefore, the central bank can afford to lower nominal rates and keep its current restraint on the economy.
- We now think the central bank can start cutting rates as soon as spring 2024.
- Of course, any major geopolitical shock, that would reverse the current market rate structure, would at least partially alter that view.
- There is also the sword of Damocles over the US budget: congress has only one month left to agree a budget extension and avoid a shutdown. But first the Republicans need to choose a House Speaker, and currently the party is busy infighting.

In the Eurozone we believe there are similarities:

- Demand for credit from private and non-financial corporations is dropping fast.
- A measure such as credit impulse has now dropped to levels last seen during the GFC.
- Contrary to the US, inflation is proving to be stickier.
- However, inflation is harder to calculate due to the various national initiatives: from the French government preparing to support families with their energy bills in 2024 - to the tune of Euros 10 billion, to the Italian initiative of fighting inflation in Q1 2024, ('il trimestre anti-inflazione'): producers of essential items, (such as Barilla or Nestlé), distributors and supermarket chains collectively decided to lower prices by 3 to 10% or more on thousands of essential items.
- The picture for the ECB is further complicated by the wide regional differences in current inflation and expected growth.
- Another complication is the widening of French and Italian yield spreads, versus Germany: both countries announced large budget deficits an average of 4.5% for 2023 and 2024, defying Brussels' budgetary rules.

We thus believe that the ECB will keep rates at the current level for longer than its American counterpart, and only start to lower rates towards the middle or end of summer, 2024.

Swiss National Bank

The central bank completely changed its approach to fighting inflation late last year: it mentioned that besides interest rates, it could use the currency as a tool. The bank recently published the quarterly data about its foreign exchange transactions, which is published with a 3-months delay. The central bank actually stepped up its purchases of its own currency, by buying a whopping 40 billion Swiss Francs, after 32 billion in Q1 and 27 billion in Q4 2022. The central bank has now repurchased more than 100 billion of Swiss Francs. Its balance sheet, between negative market drift and currency purchases, has dropped to, (a still high), 680 billion, from 950 billion in January 2022. No wonder the currency didn't weaken against the Euro, when the Euro recovered from 96 cents to 1.12 versus the USD, as it looked likely that Europe would avoid a large-scale energy crisis.

China

As we pointed out last month, economic policy tailwinds are gathering momentum, and recent data indicate that Beijing's policies are starting to bear fruit. September data confirm that:

- GDP growth of 4.9%.
- September retail sales, at +5.5%, were more robust than expected.
- Fixed asset investments disappointed slightly at 3.1%, while property investments tumbled 9.1%.

The latest inflation figure, at 0%, renewed fears of deflation in the country. Prices of pork, which can be extremely volatile, with a 3% weighting, have an outsized influence on the index. Last month they were down 22% year over year: it means ex Pork, inflation would have printed around 0.7%. During the first week of October, the Chinese were off vacationing for Golden week. Initial data are encouraging in terms of quantity of travel, while average spending is a bit below expectations.

Recently, there is much talk about another 1 trillion fiscal stimulus plan, while several sources indicate that the government has instructed state owned banks to roll over existing local government debt with longer maturities at lower rates.

Local government debt is a huge problem, as it has ballooned to almost 13 trillion USD, or over 75% of GDP. Just days ago, the sovereign wealth fund boosted stakes in 4 domestic banks, the first time the 'National Team' was seen in the market since the stock crash of 2012. There is also talk about the creation of a proper stabilization fund to support the stock market.

Looking at flows via the 'Northbound Shanghai-Hong Kong Connect', through which foreign investors must pass to purchase domestic Chinese stocks, it is evident that foreigners are still pulling money out of the market, albeit at a slower pace. On the other side of the border, domestic investors appear to be timidly putting money to work.

Before increasing our Chinese exposure, we need more evidence that the government's policies are working effectively. We also need to see a convincing plan to address the real estate sector.

Strategy

Our central scenario continues to be that:

- The US will achieve a soft landing, inflation will slowly move towards target, and the central bank is done with hiking, and will be able to start cutting rates in spring.
- The Eurozone will avoid a recession, however economically it is likely to resemble a patchwork, both for inflation and growth: Germany and the Netherlands will likely enter one, while Italy will straddle the zero-growth line. Inflation in Europe is likely to be higher than target in 2024, however the ECB is likely done with hiking, as food prices, for example, are non-interest rate sensitive. The ECB will start to lower rates by late summer, and not spring as the market implies.
- China looks like it is finally managing to pull its economy out from the doldrums. That should help Chinese and regional markets, and finally draw interest from foreign investors again.
- Japan is facing a reflationary dynamic it has waited to see for the last 30 years. It is uncertain whether the Bank of Japan will intervene to curb YEN weakness at the 150 level like last autumn.

- As the world economy is expected to improve in 2024, we think that earnings revisions should continue higher. In the US, profit margins have been declining since 2021: we expect some stabilization. In Europe they have been stable to higher, and we expect some stagnation until China stabilizes.
- We are thus positive for the performance of the classic 50/50 portfolio over the next couple of quarters.

Asset Allocation Changes

In view of the comments above on USD rates and likely action by the US Federal Reserve, just before the tragic events in Israel, we decided to lower the credit risk on the USD fixed income exposure and extend duration. USD investment grade, of intermediate maturity, has outperformed the US aggregate benchmark by 4.5% since we implemented and completed the fixed income exposure in late summer of last year. Recently, we cut our overweight Euro investment grade exposure in favor of 1-to-3-year sovereigns. We thus now find ourselves with a Treasury 'barbell': long short-term sovereigns and long 20 + US treasuries.

In the current situation, we see several benefits with this positioning:

- In the case of a soft economic landing the Federal Reserve will lower rates in 2024, thus short-term bonds should rise, while the longer end should stay stable, while providing carry, bringing us back to a normal upwardly sloped yield curve.
- In the lower probability case of a hard landing, the US central bank would be even more aggressive in cutting rates, thus benefiting the entire curve.
- The speculative community is extremely short long-term bonds, while the traditional asset managers are rather short in duration. Any squeeze in rates lower could push them to cover/ extend duration if we are correct in our assumptions.
- Recent indicators point to credit demand for households and corporates being negatively impacted by current high rates. Lower, and middle, income households are already starting to suffer from high mortgages, high credit card rates, the return of student loan payments, and the pandemic savings all but gone.
- We acknowledge it is still possible for the central bank to increase rates again, and potentially commit a monetary policy mistake. Then, as history tells us, the central bank would, after a few months, try to correct its 'mistake' by cutting rates quickly.
- The risk, of course, is of another inflation shock, or, currently, a worsening of the situation in the Middle East. In this case, US treasuries would provide a safe haven, as credit spreads could widen dramatically.

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Positioning

Overall Exposure

We are slightly Underweight Equities, and Neutral Fixed Income, with a Gold position, partially USD and JPY hedged.

Equity: Slight Underweight

We have a very sizeable Underweight in US equities, and a very sizeable Overweight to the Eurozone, Neutral US technology, Neutral UK, Overweight Japan, Overweight Asia ex Japan.

Thematic Equities

European Family Holdings, Asian Technology, Health Improving Technologies and Services, European Recovery, Megatrends.

Fixed Income: Neutral

Underweight Sovereigns, Overweight Investment Grade USD and EUR Bonds.

Thematic Fixed Income

Overweight High Yield in EUR and Underweight in USD. Overweight Investment Grade EUR and USD Bonds, Underweight Sovereigns. Long US Municipal Infrastructure Bonds, Long Hybrids, Long Financial Credit & Long Asian Bonds.

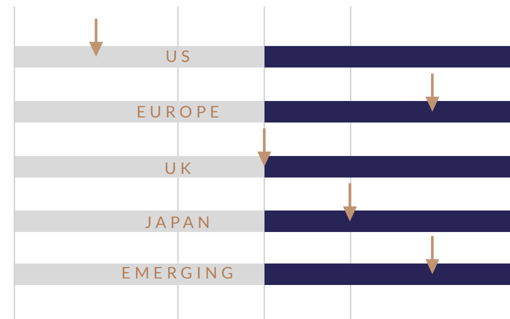
Currencies: Portfolios have a 5% USD exposure.

Commodities: Overweight

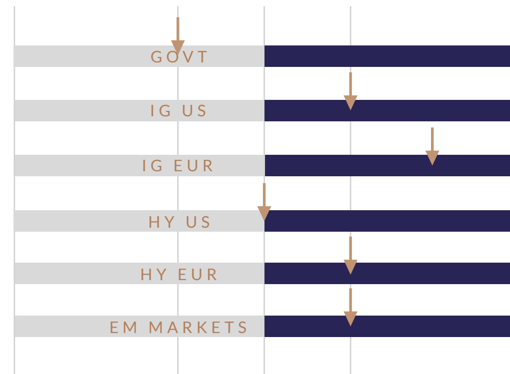
Long Gold.

Conviction thermometer

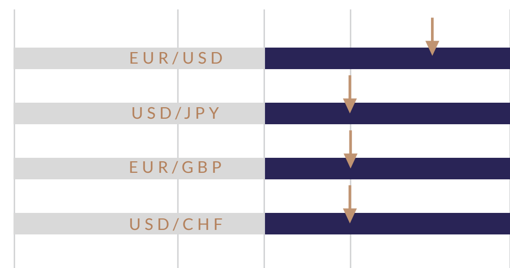
Equities



Bonds



Currencies



Commodities

Negative view   Positive view

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Market overview as of 30th September 2023

Equities (local ccies)	Level	5D	MTD	YTD	2022
MSCI WORLD	2 853,24	-0,85%	-4,28%	11,56%	-17,71%
US S&P500	4 288,05	-0,71%	-4,77%	13,06%	-18,13%
NASDAQ 100	14 715,24	0,10%	-5,02%	35,37%	-32,38%
RUSSELL 2000	1 785,10	0,55%	-5,89%	2,51%	-20,46%
EUROPE EURO STOXX 50	4 174,66	-0,77%	-2,77%	13,42%	-8,55%
GERMANY DAX	15 386,58	-1,10%	-3,51%	10,51%	-12,35%
FRANCE CAC40	7 135,06	-0,69%	-2,37%	13,38%	-6,71%
BELGIUM BEL20	3 553,01	-2,25%	-3,08%	-1,41%	-11,47%
SWISS MARKET INDEX	10 963,50	-0,45%	-1,33%	5,38%	-14,29%
UK FTSE100	7 608,08	-0,89%	2,40%	5,25%	4,57%
JAPAN TOPIX	2 323,39	-1,45%	0,42%	25,58%	-2,48%
MSCI EMERGING	952,78	-1,16%	-2,61%	2,07%	-19,81%
BRAZIL IBOVESPA	116 565	0,48%	0,71%	6,22%	4,69%
CHINA CSI 300	4 563,77	-1,31%	-1,96%	-2,50%	-19,83%
HS TECH	3 920,59	-1,77%	-6,17%	-4,61%	-26,66%
INDIA SENSEX	65 828,41	-0,27%	1,54%	9,43%	5,77%
KOREA KOSPI	2 663,34	-1,71%	-3,56%	10,76%	-23,21%
HONG KONG HANG SENG	17 809,66	-1,37%	-2,58%	-6,83%	-12,56%
AUSTRALIA ALL-SHARE	4 127,24	-0,99%	1,82%	4,33%	0,23%
SAUDI ARABIA TADAWUL	N.A.	0,97%	-3,47%	8,73%	-4,96%

US: Sectors	Level	5D	MTD	YTD	2022
COMMUNICATION SVCS	222,21	-0,01%	-3,26%	40,43%	-39,89%
CONSUMER DISCRETIONARY	1 264,00	-0,27%	-5,98%	26,58%	-37,03%
CONSUMER STAPLES	727,36	-1,97%	-4,53%	-4,76%	-0,62%
ENERGY	694,19	1,31%	2,63%	5,99%	65,43%
FINANCIALS	552,16	-1,55%	-3,14%	-1,65%	-10,57%
HEALTH CARE	1 501,22	-1,10%	-2,96%	-4,09%	-1,95%
INDUSTRIALS	857,57	-0,44%	-5,96%	4,50%	-5,51%
INFORMATION TECHNOLOGY	2 905,56	-0,08%	-6,87%	34,72%	-28,19%
MATERIALS	494,54	0,24%	-4,78%	2,61%	-12,28%
REAL ESTATE	213,82	-1,41%	-7,25%	-5,51%	-26,21%
UTILITIES	299,20	-6,92%	-5,63%	-14,41%	1,56%

EUROPE: Sectors	Level	5D	MTD	YTD	2022
BASIC MATERIALS	2 788,64	0,88%	0,63%	-1,70%	-2,41%
CONSUMER GOODS	3 959,06	-2,43%	-3,75%	-2,02%	-7,73%
CONSUMER SERVICES	1 412,49	-1,74%	-4,26%	13,37%	-15,22%
FINANCIALS	844,68	-0,21%	1,71%	17,12%	-1,93%
HEALTH CARE	3 530,18	-0,23%	-1,00%	9,12%	-3,72%
INDUSTRIALS	3 251,35	1,40%	-2,82%	12,18%	-18,88%
OIL & GAS	1 547,97	0,20%	6,24%	10,27%	30,59%
TECHNOLOGY	1 454,98	-0,48%	-6,02%	14,65%	-25,49%
TELECOMS	515,60	-3,22%	0,22%	5,88%	-13,24%
UTILITIES	1 867,26	-3,71%	-4,54%	3,72%	-6,99%

Market overview as of 30th September 2023

Fixed Income	Level	5D	MTD	YTD	2022
Pan-Euro 3-5 yrs IG	196,21	0,00%	-0,68%	1,83%	-11,37%
Euro Aggregate	222,87	-0,51%	-2,08%	0,59%	-17,18%
Pan-Euro HY Hedged Eur	396,31	-0,24%	0,42%	6,39%	-10,72%
Global Inflation hedged EUR	225,40	-1,35%	-2,62%	-3,30%	-18,94%
US Corp High Yield	2 264,90	-0,42%	-1,18%	5,86%	-11,19%
EM USD Aggregate TR	1 260,87	-0,99%	-2,28%	0,91%	-15,26%
EM Aggregate TR Local Ccy	136,82	-0,66%	-2,04%	-0,04%	-8,44%
EUR Banks CoCo Tier 1	131,70	-0,93%	-0,49%	-3,79%	-12,63%
EU GOVT HEDGED EUR	198,01	-0,76%	-2,30%	-0,90%	-20,38%
Global Aggregate	2 554,99	-0,93%	-2,92%	-2,21%	-16,25%

Commodities	Level	5D	MTD	YTD	2022
GOLD	1 848,63	-3,98%	-4,72%	1,35%	-3,64%
COPPER	373,75	1,96%	-0,93%	-1,92%	26,84%
OIL WTI	90,79	0,84%	8,56%	13,12%	55,01%
OIL BRENT	95,31	2,19%	9,73%	10,94%	50,15%

Currencies	Rate	5D	MTD	YTD	2022
EURUSD	1,0573	-0,75%	-2,49%	-1,23%	-6,93%
GBPUSD	1,2199	-0,34%	-3,74%	0,96%	-1,01%
USDJPY	149,3700	0,67%	2,63%	13,92%	11,46%
USDCHF	0,9153	0,96%	3,61%	-1,00%	3,13%
AUDUSD	0,6435	-0,09%	-0,76%	-5,55%	-5,60%
EURCHF	0,9676	0,17%	1,02%	-2,22%	-11,08%
USDCNY	7,2980	N.A.	0,54%	5,79%	5,28%
USDKRW	1 349,40	0,85%	2,00%	3,86%	4,22%
USDINR	83,0400	0,12%	0,31%	0,37%	9,13%
USDIDR	15 460,00	0,55%	1,51%	-0,73%	7,42%
USDBRL	5,0325	1,95%	1,56%	-7,55%	7,26%
USDTRY	27,4223	0,94%	2,72%	46,56%	78,81%
BITCOIN	26 903,18	1,38%	3,42%	62,27%	-64,30%

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