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Capicura Partners – Outlook 4th Quarter 2023

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"Covid-Pocket-Money" spent – how strong is consumption?

- ***Swiss National Bank demonstrates independence yet again***
- ***Market leaders 2023 show signs of fatigue***
- ***S&P500 risk premium at lowest level since 2007***
- ***Bond markets indicate recession – equity markets see soft landing***
- ***Hold on to defensive asset allocation***

We are sticking to our "mantra" - interest rates will remain high and probably for longer than we wish for. Accordingly, risks to the global economy remain to the downside and a soft landing becomes a challenging balancing act. Inflation rates on both sides of the Atlantic are falling (somewhat less in Europe than in the US), but still remain well above the levels that central bank policymakers have set as their targets. The major exception remains the SNB (Swiss National Bank), which is now able to pursue an almost independent monetary policy path thanks to Switzerland's favorable inflation environment. The monetary watchdogs are not tired of warning that the battle against inflation is far from won and remain restrictive.

Fig. 1) 10y US Treasury yields
Data: Bloomberg / Chart Capicura Partners

We expect that the "higher for longer" interest rate expectations will now also work their way into the yield curves, i.e. that they will become somewhat flatter (but still remain inverse). From a technical perspective, 10-year US government bond yields broke through the important resistance at around 4.35% to the upside last week and can quickly trend towards 5% (see Fig. 1).

«No interest rate cuts in sight»

The hoped-for interest rate cuts during H1 2024 are therefore off the table for the moment, and expectations for first downward adjustments are being pushed further down the line. Something that the market is only now slowly beginning to believe and pricing in accordingly. Central banks will remain data dependent which means, their monetary reins will only be loosened when core inflation falls near their 2% targets or the economy maneuvers into a recession. As the effects of the massive interest rate hikes of recent months are only gradually being felt, there is a risk that central banks will stick to their restrictive policy for too long and thus bring about a recession. This would lead to the widely feared "Policy Mistake". In addition to the already weakening manufacturing sector in Europe and the US, the service sector has now also been affected.

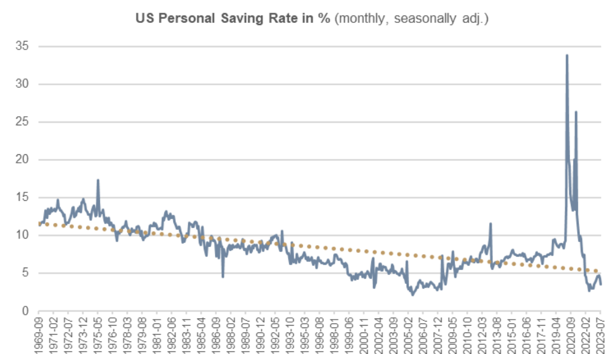

***Fig. 2) US Personal Saving Rate in %** (monthly, seasonally adj.). Data Fed. Reserve of St. Louis / Chart Capicura Partners*

The PMIs (purchasing managers' indices), which are regarded as leading indicators, have been warning of weakening economic momentum for some time. The only supporting factor is the still solid labor market (but as we know, this is a lagging indicator). Since consumption is responsible for two-thirds of US GDP (gross domestic product), this component must be watched closely. The consumer appears to have spent much of his "savings" accumulated during Covid (see Fig. 2). In addition, the sharp rise in prices and interest rates is also slowly but surely leaving its mark on the consumer's wallet. Furthermore, from October 1, around 43 million Americans will have to service their student loans again (the three-year moratorium due to the pandemic is coming to an end), which is also likely

to have a negative impact on consumer behavior. It is also becoming apparent that there is a threat of another government shutdown in the USA from October 1, which would also have a negative impact on the overall sentiment (depending on how long it will last).

«US fiscal stimulus and ample liquidity countered rate hikes»

The inverse US yield curve continues to indicate trouble ahead for the US economy. We acknowledge that so far, the US economy and US corporates have been surprisingly robust and are stomaching the higher interest rate environment well. However, we need to consider that ample US fiscal stimulus and the still elevated money supply has taken an edge off the higher interest rates. On top, the low interest rate phase was utilized to finance longer term, postponing the burden of higher interest rates to the future. Still, we take guidance from the bond markets and expect the higher interest rates to eventually take their toll on the US economy. With the Chinese property market in turmoil and the sector representing 20 – 30% of Chinese GDP, little near-term help is expected from the world's second largest economy. Only Chinese fiscal stimulus could come to the rescue. Europe is already showing substantial signs of weakness with its largest economy Germany leading the way down. With commodity prices trading sideways/lower in general, the oil price seems to be the big exception and has continued to rise against all odds. The popular explanation is tight supplies today and further tightening tomorrow. Fundamentals, however, fail to support these expectations. The storage situation in North America, Europe and China remains ample and is unlikely to tighten with production picking up and expectations of slower demand due to a softer economy.

«S&P500 Risk Premium at lowest level in 16 years»

In our last quarterly outlook, we already stressed our concern regarding equity markets in general and with the US equity market and US technology stocks in particular. This skepticism has not changed as the S&P500 equity risk premium has fallen to its lowest level since mid 2007 (see Fig. 3). This indicates that the investor hardly gets awarded for owning equities over Treasuries at the current stage. With some of the market leaders now showing signs of weakness and the leading Nasdaq100 index having lost more than 8.5% from its July highs, the market looks vulnerable to correct further.

Fig. 3) S&P500 Risk Premium
Data: Bloomberg / Chart: Capicura Partners

«Keep defensive positioning in place»

With the 10year Treasury yield remaining stubbornly high, we struggle to see any meaningful potential for equities in the near-term, especially as fixed income and even cash have become investable again offering an alternative to an uncertain equity market. We admit having underestimated the excess liquidity in the system combined with the expansive US fiscal measures which have managed to propel equity markets higher this year. This after the terrible 2022 in which equity and bond markets were burdened by the war in Ukraine, broken supply chains and a historic increase of interest rates. But based on our concerns outlined above, we prefer to be on the safe side and confirm our defensive positioning leaving our asset allocation unchanged.

Asset Allocation	
Cash	10%
Fixed Income	25%
Equities	40%
Alternative Investments	25%

Fig. 4) *Suggested asset allocation for a Balanced Portfolio in Q4 2023*

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