Capicura Partners – Outlook 1st Quarter 2024

December 15, 2023

Interest Rate wishes for 2024 will not be fulfilled

- ***Change of heart at the US Federal Reserve - fears of a meaningful economic slowdown on the rise***
- ***US Treasury needs to issue debt – FED needs to shorten balance sheet***
- ***Market sentiment too optimistic – expect some sobering up in Q1***
- ***Swiss blue chips with catch-up potential***
- ***Asset allocation – defensive positioning in Q1***

With the year coming to a close, we look back on the past 12 months and try to look forward on next year's financial markets. 2023 was a year of two halves. January to July equity markets pushed higher despite bank failures and interest rates creeping up. From end of July, equity markets struggled as investors needed to adapt to higher interest rates for longer. It is also worth noting that although the feared US recession has failed to materialise so far, the Eurozone and Germany in particular are struggling with negative growth figures. China is also weakening despite reopening after Covid due to ongoing problems in the property sector. The tragic attack on Israel at the beginning of October added to investor concerns and uncertainty. Nevertheless, the equity and bond markets embarked on a classical year-end rally at the end of October. This early "Christmas rally" was fuelled by the growing conviction that central banks will cut interest rates significantly in 2024 and that the US economy will manage a soft landing. The 10-year US Treasury yield fell from over 5% to below 4% in just two months!

«Speed and extent of expected interest rate cuts are exaggerated»

At its December meeting, the US Federal Reserve held out the prospect of possible interest rate cuts in 2024 for the first time. The so-called "dot plot" (individual FOMC members' expectations of the interest rate path) sees interest rate cuts in the order of 75bp. However, market participants are currently assuming that the US Federal Reserve will cut interest rates (even more significantly) by 150bp in 2024 (see Fig. 1). According to the market, the ECB is expected to cut interest rates by more than 140bp in the same period. In Switzerland, the interest rate peak has also been reached but a reduction will not take place until the second half of the year at the earliest due to the still low interest rate level (both in nominal and real terms). We believe that market expectations are largely exaggerated. It remains a tightrope walk for the US Federal Reserve. It does not want to put unnecessary strain on the economy, but at the same time it desperately wants to prevent inflation from flaring up again.

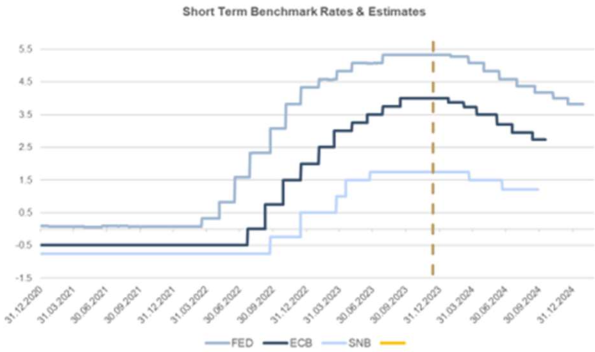

Fig. 1) Expected Central Bank interest rate path
Data: Bloomberg / Chart Capicura Partners

«Who will be filling in the gap?»

Another reason for US yields to remain elevated for longer is the fact that the Treasury needs to issue fresh debt. Total US debt amounts to USD 33.2 trillion or 120% of US GDP at the end of Q3 2023. Debt servicing costs represent roughly 20% of government spending. As the Federal Reserve reduces its holdings of Treasuries under quantitative tightening and issuance grows, investors must swallow ever-greater quantities of the bonds. There is also a risk that Japan, the USA's largest creditor, will repatriate capital due to rising JPY interest rates and large unrealized currency gains. This is likely to put further pressure on prices – what yield must these Treasuries offer?

«A US recession is not off the table»

The US economy has proven to be extraordinarily resilient despite sharp interest rate hikes in the last two years. Historically, such "interest rate shocks" have led to a recession (see Fig. 2). On average, a recession has been observed 8 ½ months after the last interest rate hike (the FED raised interest rates for the last time at the end of July).

Fig. 2) FED Funds vs. 2Y Treasuries & US Recessions
Data: Bloomberg / Chart: Capicura Partners

Despite possible interest rate cuts, a weakening labor market and corresponding change in sentiment among US consumers could lead to a recession in 2024. The historical comparison of the US equity market (S&P500) and the US JOLTS (job openings) is striking. Figure 3) shows the current strong divergence.

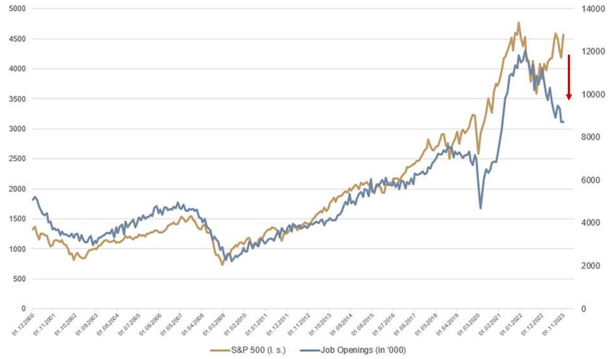

Fig. 3) S&P500 vs. US Job Openings (JOLTS)
Data: Bloomberg / Chart: Capicura Partners

«The higher the likelihood of a Trump victory, the more of a CHF»

Another aspect that is currently being largely ignored by the financial markets is the US elections, which are due next November. Without Donald Trump having taken part in any TV debates so far, he is considered to have very good chances of re-election. A return to populist US politics harbors risks. The closer the election date approaches, the more these risks are likely to be discounted by the financial markets with increased volatility. The functioning Swiss democracy, coupled with low government debt, make the CHF a structurally strong currency and once again a safe haven in the new year.

«Financial markets are too optimistic»

The current overly optimistic investor sentiment (various indicators) and the low volatility levels (VIX) suggest that the financial markets are overheated – a warning sign from a contrarian's point of view. The euphoria at the end of the year is likely to subside in the first quarter and volatility is expected to increase again. Now that interest rate cuts are on the cards; the market will increasingly focus on economic and corporate data. Poor data should not lead to even lower interest rates, but rather to weaker equity markets.

«The environment will remain challenging»

We used the setbacks in October to rebalance the portfolios. As a result, the current equity allocation in our balanced portfolio rose to around 45% due to performance. Given that uncertainties prevail, we remain underweight in equities (neutral positioning would be 50%) and are maintaining our overweight in Swiss equities within the quota. The Swiss equity market was an underperformer this year and has catch-up potential for 2024. To become more constructive, we need additional certainty that inflation has been defeated, that the FED will put its money where its mouth is, and that the US economy will master a soft landing.

Asset Allocation	
Cash	*10%*
Fixed Income	*25%*
Equities	*45%*
Alternative Investments	*20%*

Fig. 4) *Suggested asset allocation for a Balanced Portfolio in Q1 2024*

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Finally, we would like to pay tribute to Charles Munger, the famous partner of Warren Buffet at Berkshire Hathaway. Mr. Munger passed on 28th November of this year, 33 days before his 100th birthday. One of his famous quotes was - "We have three baskets for investing: yes, no, and too tough to understand." – we sincerely hope that financial markets in 2024 will not be "too tough to understand" and wish you and your loved ones a joyful festive season and a good and healthy new year.