Capicura Partners – Outlook 4th Quarter 2024

September 27, 2024

If in doubt – stay invested

- ***Market breadth improved – S&P 500 equal weight with new all-time high***
- ***Harris or Trump – US fiscal policy remains expansive either way***
- ***FED tries to get ahead of the US economy – a soft landing looks more like «mission impossible»***
- ***SNB on track – further interest rate cuts only on back of additional CHF strength***
- ***Asset allocation confirmed***

In our last outlook we highlighted the dominance of a few large US technology stocks and their strong contribution to the increase in the market capitalization-weighted S&P 500 Index. Also, we mentioned the high earnings expectations for the second quarter and the associated risk of a market correction. While we indeed saw a setback in the beginning of August, it had little to do with any of the above, as more than 80% of US companies exceeded their earnings expectations. The correction was due to the Bank of Japan (BoJ) raising interest rates and the subsequent appreciation of the JPY against the USD. This led to a reversal of crowded carry trades (short JPY due to low interest rates, long US assets) by professional investors. This technical correction was short lived and in the meantime the market breadth has fortunately increased – the upward trend is no longer driven by just a handful of stocks. This is illustrated by the comparison between the market weighted and the equally weighted S&P 500 Index since the end of June (Fig. 1).

Fig. 1) Market weighted vs. equal weighted S&P 500 Index
Data: Bloomberg / Chart Capicura Partners

The latter has recouped some of its underperformance since the beginning of the year and has reached new highs. We consider this rotation a healthy development which suggests a continuation of constructive equity markets.

«US elections – the majorities in Congress are relevant»

However, we should not forget that market participants have so far ignored geopolitical risks (Ukraine and the Middle East) as well as the US elections. Although volatility has normalized since the market correction in August, it is likely to increase again ahead of the elections on November 5. According to current polls, Vice President Harris is slightly ahead, but it remains a neck-and-neck race. Regardless of the result and party affiliation, the trend towards more debt is a given due to austerity being absent in both campaigns (Fig. 2).

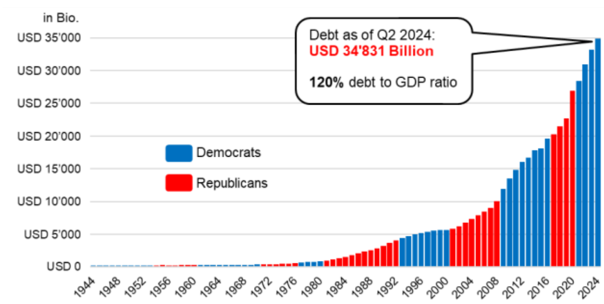

Fig. 2) US government debt 1944-2024
Data: FRED / Chart: Capicura Partners

The decisive factor for the financial markets will be the composition of the US Congress. Regardless of who wins the election, a divided parliament would be beneficial for the US budget, long-term interest rates and the development of the US dollar, as the risk of excessive fiscal programs would be contained. Nevertheless, debt remains an unresolved problem, both in the US and in Europe. This continues to argue in favor of a strategic allocation to gold, although the sharp rise since the beginning of the year makes the precious metal vulnerable to corrections in the short-term.

«US interest rate pivot initiated with jumbo cut»

With last week’s meaningful 50 basis points (0.5%-points) rate cut, the FED kicked off a new interest rate cycle. Despite this step, the US central bank continues to remain restrictive, as further reductions are still to come before the neutral interest rate level is reached. FED Chairman Jerome Powell justifies the extent of the reduction with the improvement in inflation and his intention to stabilize the labour market, which showed first signs of weakening in summer. However, the reason for the rise in the US unemployment rate is primarily due to increased immigration and seasonality, as the layoff rate remains at a historically low level. Another reason for Powell's often-cited «jumbo cut» is the attempt to maneuver the US economy into a soft landing (economic slowdown without recession). Soft landings seldomly work and only time will tell if Jerome Powell alias Tom Cruise can pull of this «mission impossible».

«Recession not ruled out»

While market participants are tied up with anticipating how many interest rate cuts are in the cards, we take comfort in the fact that short-term interest rates have peaked and a new interest rate cycle has begun. For now, this bodes well for equity markets. Nevertheless, a certain residual risk of a recession remains, which is why we are treating the market euphoria with a certain degree of skepticism. Past experience shows that a US recession has always occurred a few months after the first interest rate cut (Fig. 3).

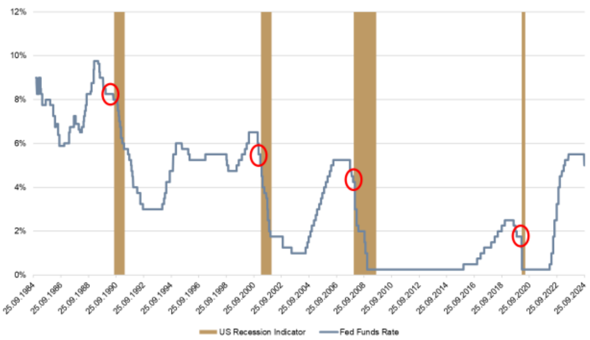

Fig. 3) Fed funds rate and US recessions
Data: Bloomberg / Chart Capicura Partners

It remains to be seen whether history repeats itself or if «Tom Cruise» manages to avoid a recession.

«Thomas Jordan’s last dance»

Except for the BoJ, the interest rate peak has been triggered by most major central banks. As expected, the ECB cut interest rates for the second time by 25 basis points at the beginning of September and will need to support the ailing economy (primarily Germany) with further interest rate cuts, especially as inflation is on target. In Switzerland, price appreciation is under control too, which is why Thomas Jordan, Chairman of the Swiss National Bank (SNB), has cut interest rates for a third time by 0.25 percentage points to 1.0% as his last official act (Martin Schlegel will take over on October 1, 2024). In doing so, he is supporting the weakening industrial sector but has robbed his successor’s room to maneuver in a potential downturn. We do not expect any further interest rate cuts in Switzerland this year, unless the CHF appreciates further against the EUR and USD. The market is assuming further significant interest rate cuts over the next six months (SNB -50bp, ECB -100bp, FED -130bp). We do not doubt the direction, but rather the extent, as various economic indicators such as consumption, the service sector and the labour market still look too robust.

«Entering last quarter with an unchanged asset allocation»

Investors will be keeping a close eye on the upcoming labour and economic data for a possible soft landing scenario. Furthermore, the earnings season of the third quarter will start from mid-October. Forecasts have been continually adjusted downwards in recent months (expected earnings growth of +4.6% compared to +7.8% at the end of June), which is why they are unlikely to disappoint. It will therefore be the companies' outlook that will show us the way in equity markets. As the upward trend is currently the path of least resistance, we maintain our constructive positioning going into the last quarter of the year.

Asset Allocation	
Cash	5%
Fixed Income	25%
Equities	50%
Alternative Investments	20%

Fig. 4) *Suggested asset allocation for a Balanced Portfolio in Q4 2024*