

«Autumn storms instead of a bear market»

Despite numerous headwinds such as rising interest rates, geopolitical uncertainty, high government deficits and elevated energy prices, the fundamental backdrop for equities remains constructive. The greatest danger stems from a further rise in long-term US yields. Corporate earnings, however, continue to grow strongly and valuations are elevated, but not extreme. We therefore consider a correction within an intact bull market more likely than the start of a bear market. Once the US midterm elections are over, the chances of a year-end rally improve.

At a glance

New Fed Chair Kevin Warsh passes his baptism of fire with flying colours

US Treasury Secretary Scott Bessent loses credibility

Negative equity risk premium calls for caution

AI remains the engine of growth

After the US midterms: chance of a year-end rally

Asset allocation: equity weighting confirmed

Warsh passes his baptism of fire

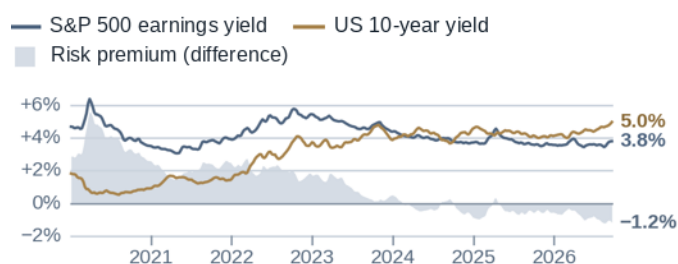
The fourth quarter begins with a turning point in monetary policy. Under Kevin Warsh, the US Federal Reserve has raised interest rates for the first time in three years. The unanimous decision builds trust and shows that Warsh acts independently of political pressure. Treasury Secretary Scott Bessent cuts a very different figure. By tripling bond buybacks at the long end and declaring the Treasury to be «the house», he has lost credibility. The buybacks are merely a drop in the ocean, yet they fuel speculation about yield curve control. The fact that the Treasury has to intervene at all shows how heavily debt weighs on the markets. Yields on long-dated US Treasuries are rising towards 5% accordingly. This level will decide the room to the upside for equity markets.

Risk premium calls for caution

For now, markets are holding up better than the headlines would suggest. Despite an oil price of around USD 100 and US inflation of 3.4%, the S&P 500 is trading close to its all-time high and is up roughly 14% year to date in USD. All this in spite of a long list of burdens. Seasonality, the midterms, the Middle East conflict, more restrictive central banks, government debt and trade disputes such as the one between the USA and Canada are all testing investors. Things become critical if the yield on 10-year US Treasuries rises clearly above 5%. At that point, bonds turn into a comfortable alternative. The earnings yield of the S&P 500 is already below the US 10-year Treasury yield and the risk premium has fallen to multi-year lows (Fig. 1).

Strong corporate earnings stand in contrast. Solid purchasing managers' indices and a robust US labour market are signs of a growing economy. Earnings growth of 28.9% and revenue growth of 11.9% are expected for the third quarter, and 15.2% and 9.1% respectively for 2027. At an expected price-earnings ratio of 19.1x, the valuation is elevated but still below its 5-year average (Fig. 2). Barring significant earnings revisions, a potential correction should be limited to around 10%. Only the combination of high interest rates and weaker earnings would be dangerous.

Fig. 1 S&P 500 earnings yield vs. 10-year US yield



Source: Bloomberg

Fig. 2 S&P 500: expected price-earnings ratio



Source: FactSet

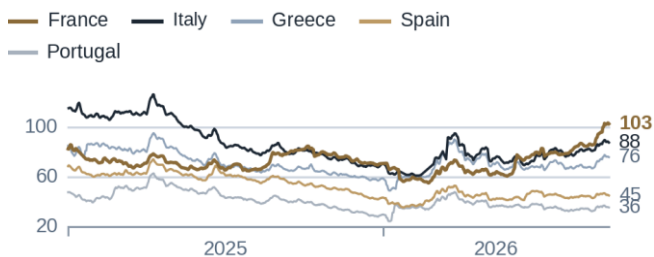
War, debt and real assets

What could put earnings under pressure? The war, most likely, as our hope for a swift de-escalation in the Middle East proved too optimistic. What matters is less the conflict itself than its impact on energy supply chains and ultimately on energy prices. That impact feeds straight back into interest rates and forms the core of our investment case «New commodity supercycle?». The battle for raw materials, a more hostile world, stubborn inflation, high debt and currency debasement (the «debasement trade») all speak in favour of real assets. Gold, silver and commodity stocks prove the point, as they are holding up well despite higher interest rates and a stronger US dollar. More on this in our commodities report [\[link\]](#).

Eurozone: debt ratios in focus

Debt turning into a driver of market prices is a phenomenon that reaches well beyond the US. Credit spreads are widening in Europe too, although the ECB's firm stance rules out a new debt crisis. Investors are, however, once again drawing sharper distinctions between public finances. The spotlight is on France, with a debt ratio of 118% of GDP, and Italy at 139%, with France's spread now even higher than Italy's. At 64%, Germany remains the anchor of stability, while Portugal and Spain, the victims of the 2012 EU debt crisis, stand out with low spreads (Fig. 3).

Fig. 3 Spread of 10-year government bonds vs. German Bunds, in basis points



Source: Bloomberg

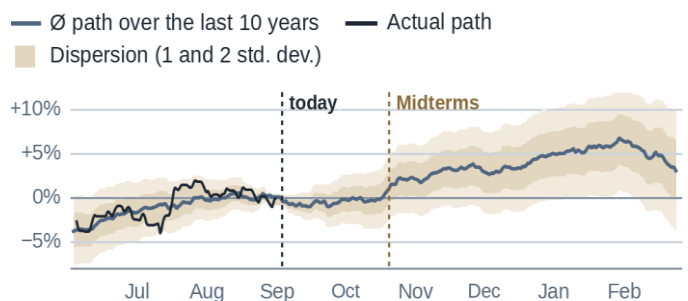
Autumn storms, then a year-end rally

In the short term, seasonality and the midterms call for patience. September and October remain challenging, but after 3rd November markets are likely to stage a year-end rally (Fig. 4). We remain invested and confirm our equity allocation of 57%. Liquidity creates options and owing to performance, the share of alternative investments has risen at the expense of cash and bonds.

AI remains the engine of growth

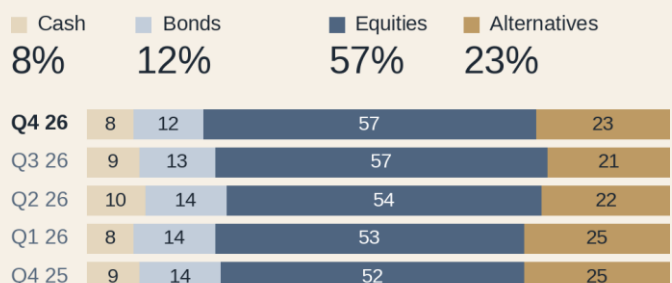
While debt dominates the bond market, almost everything on the equity side hinges on artificial intelligence. The arms race resembles a prisoner's dilemma, since nobody can be sure that competitors will respect a pause in development. So the spending continues. The cloud backlog of Amazon, Microsoft and Alphabet has more than doubled within a year. We consider fears of a bubble overblown, not least because AI has long since reached the broader economy. Around two thirds of S&P 500 companies mention the topic in their earnings calls. From 2027, productivity should rise noticeably, and tomorrow's winners will increasingly be the users. Torsten Slok (Apollo) expects AI to add roughly one percentage point to US annual growth over the next few years. Whether that will offset the weakness of the US consumer remains to be seen.

Fig. 4 S&P 500: seasonality over the last 10 years, in %



Source: Investtech

Fig. 5 Asset allocation, balanced portfolio, in %



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