Edmond de Rothschild

MARKETING COMMUNICATION

SPECIAL FLASH

FROM OVERHEAT TO RECESSION WITH NO TRANSITION?

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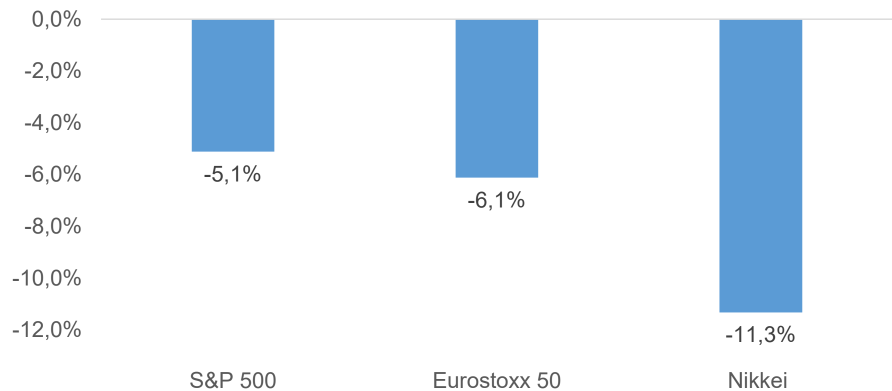
► **Equity markets almost corrected in just three days. The dip does not seem to have been triggered by a single factor, but rather by a new environment: the (finally) hawkish turnaround initiated by the Bank of Japan (with a surprise rate increase) which sent the Yen soaring; rising unemployment in the United States; and flaring geopolitical risks in the Middle East. However, the detonator was the weakness of US labour data.**

Equity market evolution since 31.07.2024

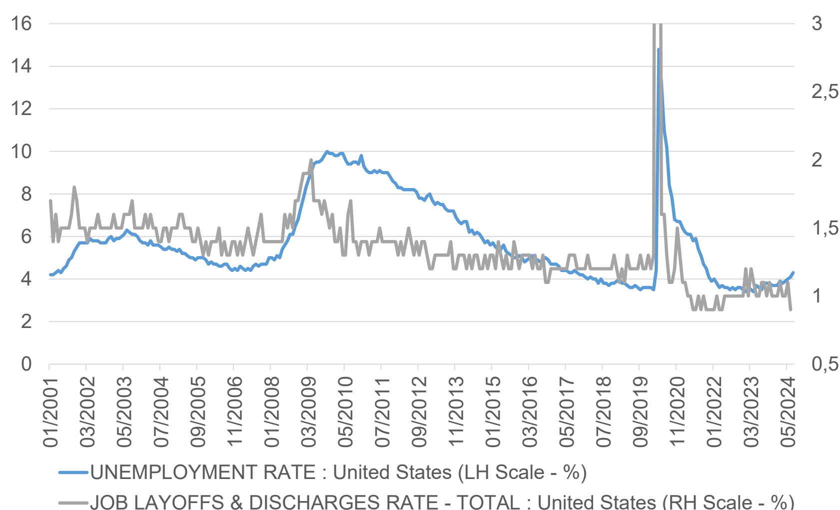


Data at market close on August 6, 2024. Source: Bloomberg. Past performance are not indicative of future performance and are not constant over time. They may be independently affected by changes in exchange rates.

ARE WE HEADING TOWARDS A RECESSION?

Investors are showing growing interest in the Sahm rule, which has observed without fail that the initial phase of a recession begins when the three-month moving average of the U.S. unemployment rate is at least half a percentage point higher than the 12-month low. And according to the most recent labour data, this is currently the case. Nevertheless, it is important to relativise these figures somewhat. We have not observed a rebound in redundancies, but sharp variations in the working population, including a resurgence of new job seekers - notably as a result of immigration, and over the past month, a large number of workers unable to get to work due to adverse weather conditions (Beryl hurricane). Long-term unemployment

has been stable over the past year. While admittedly, there has been a slowdown in new hires, higher unemployment is mostly due to more job offers. This phenomenon can only be positive for US companies, which have been suffering from labour shortages and are finally seeing wage costs begin to ease.



Data as of July 15, 2024. Source: LSEG Datastream / Edmond de Rothschild Economic Research. Past performance are not indicative of future performance and are not constant over time.

Since the start of the Covid crisis, the US economy has become much more difficult to decipher. Sectors are evolving according to different cycles, and we believe it is important not to react to single data. In this respect, it is interesting to watch the nowcasts that aggregate quarterly data. Methodologies differ but according to Bloomberg, the New York FED or the Atlanta FED, statistics are compatible with a quarterly growth rate of 1.17%, 2.11%, and 2.54% - levels that are generally lower than they were in Q2 but that are not plummeting all the same. But more importantly, beyond disagreements on statistics, the factors that would cause the economy to enter a recession - deteriorating corporate margins leading to restructuring and a financial crisis – are not apparent.

We are therefore in a slowdown phase referred to as "late cycle" which historically, implies rate cuts and decent performances for equities. The way we read the cycle, we believe it is still too early to worry about the economic risk, particularly as the FED Governor considers that inflation has weakened enough for the central bank to want to bolster the cycle.

THE BANK OF JAPAN'S BIG SHIFT

The Japanese stock market has been the worst hit so far (down by over 11% since July 31st). The intrinsic fragility of the market stems from the Bank of Japan's unexpected hawkish tilt at the end of July, and announcements of a potentially more powerful cycle of rate increases.

The central bank is positioned poles apart from the rest of the world, which is now more or less certainly rid of the inflation issue and has initiated – or is about to initiate - a rate cut cycle. This was enough to send the yen climbing, weakening the exporting companies that feature heavily in Japanese stock market indices. Particularly as in addition to the currency effect, the global economic slowdown will impact companies with higher operating leverage than their main rivals. Japan's zero rate policy has never had a happy ending, despite several attempts in recent decades. By choosing to be out of phase with its partners, the Bank of Japan is taking a serious risk.

The Japanese stock market did fall first and more violently than others. However, we do not view this movement as a leading indicator for the global stock market, but rather as reflecting a highly specific policy risk. We are not taking advantage of the correction to reposition our portfolios strategically in favour of Japanese equities.

GEOPOLITICAL RISKS REMAIN

Recent events have raised fears that the conflict between Iran and Israel may flare up. However, both parties clearly seem keen on maintaining tensions under control. Over the past few days, the falling prices of oil, gold and the dollar suggest that the geopolitical risk premium is not weighing significantly on markets at present.

THE FED TO THE RESCUE?

One element of caution is the pressure that has been mounting on the Federal Reserve to make an unscheduled rate cut ahead of the FOMC's next meeting, with investors arguing that the US central bank is now lagging the rate cut cycle.

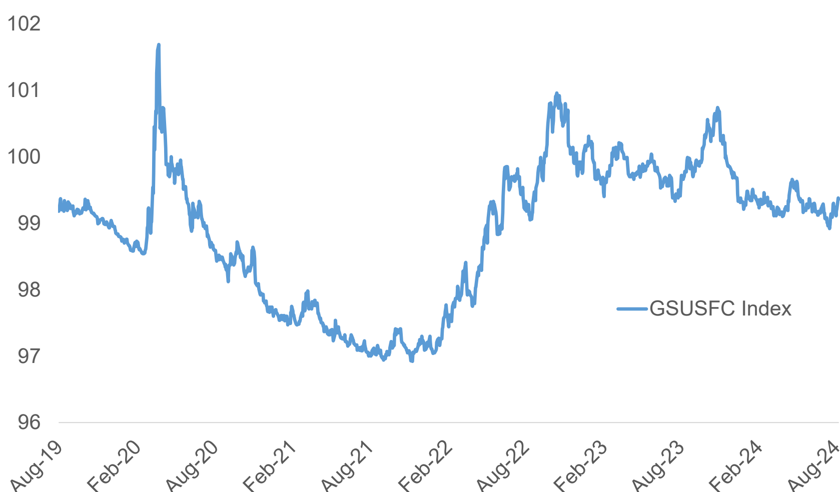
Disappointment is likely and we do not believe in this scenario. Intermeeting cuts are extremely rare and only triggered by exceptional crises, such as LTCM[1] or the market crash that followed the Kerviel scandal in the midst of the subprime crisis. While current investor behaviour does seem panic-driven, no "troublemaking" factors have been identified so far that would justify this course of action. Furthermore, lending conditions have only deteriorated

slightly (thanks to easing long-term rates).

However, one should not underestimate the potential for rate cuts, as the central bank could largely meet the market's expectations before the end of the year. The FED has already stated over the past few weeks that inflation had ebbed sufficiently and that it could now focus on addressing the possible risks to growth.

FED official estimates (dots) indicate a longer run/neutral rate of 2.75%. Markets see rates dropping to 3.2% at end 2025. Faced with a serious risk of recession, the FED would bring its key rates to below neutral – its potential for delivering positive surprises clearly remains considerable.

A rise in the index is a deterioration in financial conditions



Data as of August 6, 2024. Source: Bloomberg. Past performance are not indicative of future performance and are not constant over time.

The FED will come to the rescue if the recession becomes severe. But in the short-term, it would make no sense.

WHAT POSITIONING IN THIS MARKET ENVIRONMENT?

Admittedly, surveys pointed to some investor complacency and to high equity investment allocations. In light of the performances posted year-to-date, the weakening economic environment mentioned above triggered some profit taking during the summer months, when markets were less liquid. This profit taking had so much impact that it generated more. Panic took hold of money management.

Against this backdrop, we have not revised our allocations but are simply taking some profits on sovereign bonds that benefited from the flight to quality. We shall continue to analyse the dynamics within this fluctuating environment and are keeping a close eye on flows – as the cleansing of past overweights will be instrumental in allowing markets to regain a firmer footing.

[1] LTCM: Long Term Capital Management is a hedge fund which appeared in 1994, and whose near-bankruptcy in 1998 posed a major risk to the international banking system and caused major disruption to financial markets.

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