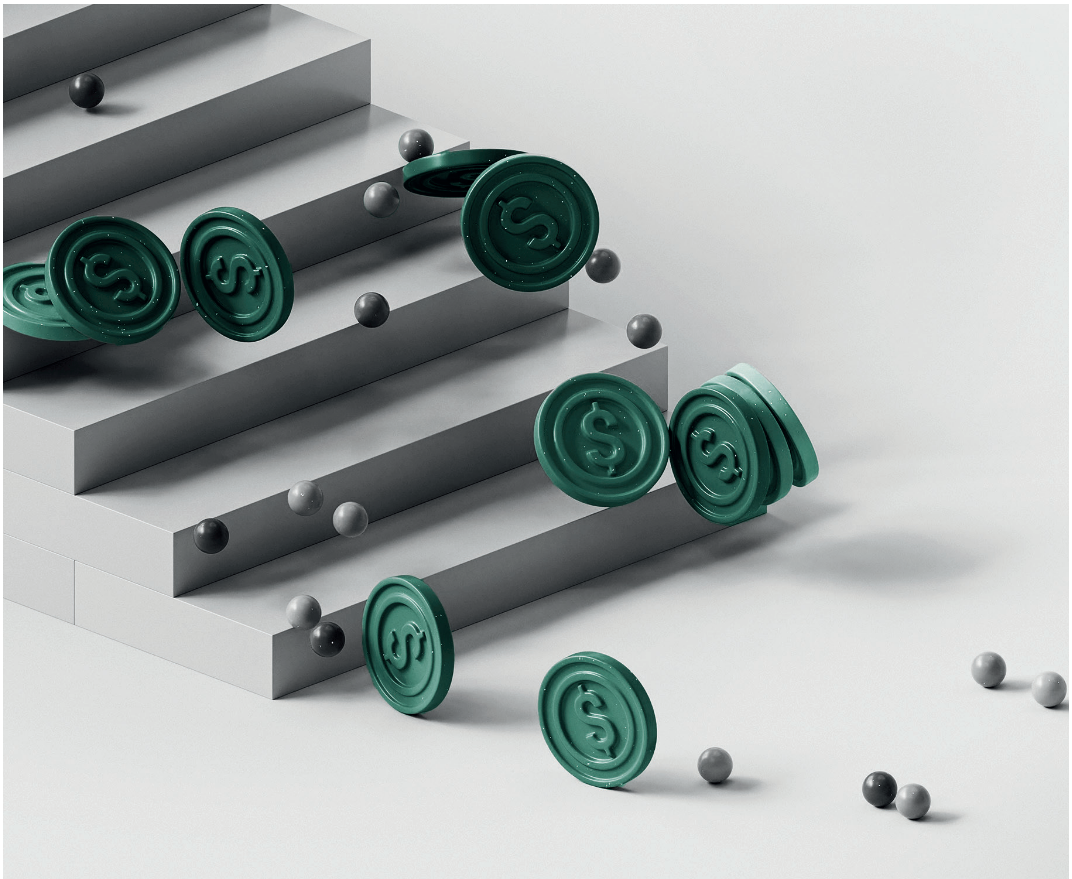
THE GREAT EASING

Q4 2024



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Dear Reader

As we enter the last quarter of the year, investors can already look back on strong performances across most asset classes. The global backdrop remains largely supportive, and barring a further and material deterioration in the situation in the Middle East, there is a fair chance that the year will end on a strong note.

The outcome of the US presidential elections will demand much attention and markets, always the discounting mechanism, will try to anticipate the ultimate winners and losers. Much of the impact, if any, will not be felt until 2025 when the new administration puts itself to work. With the race wide open at the time of writing, we recommend broad diversification as a first line of defense. Given that, coincidently, the US business cycle is also maturing, a more defensive sector positioning in equities is also warranted. Investment-grade bonds, meanwhile, still offer attractive yields for investors seeking to shore up their cash flows.

Recent developments in China have been seen by many as a real game changer. In our Special Topic we present our view of the measures announced so far and what else may be needed.

We appreciate your continued readership and, as always, look forward to your comments and questions.

Yours sincerely

Dr. David Wartenweiler, CFA
Chief Investment Officer

THE MACRO BACKDROP

Shifting down

Long-expected and long-delayed, it finally arrived: global monetary easing. With the notable exception of the Bank of Japan, almost all major central banks have now entered a new rate-cutting cycle. This should help stabilize growth, which has been softening since the beginning of the year.

Key points

- Global policy rates set to continue their decline
- No US recession on the horizon
- Europe stutters while China stimulates

US Fed goes big to start easing cycle

In September, the US Federal Reserve started its easing cycle with a bang, cutting the policy rate by a full 50 bps. Based on the Fed's own forecasts and comments, another 50 bps are to follow by year-end. Rates are expected to continue to decline, also next year, albeit at a slower pace. With inflation moving closer to the 2% objective, the Fed shifted its focus to employment, the second objective of its dual mandate, which showed some weakness during the summer quarter. While growth has held up well so far this year, some slowing is expected as the delayed effects of several years of high interest rates have started to bite. Nevertheless, a recession is no longer on the cards for this year, and currently only a remote possibility for 2025. The race for the White House meanwhile remains wide open. Both contenders propose policies that are reflationary in nature, involving either lower taxes or higher spending. Both would further challenge fiscal stability, but only Trump could potentially jeopardize the country's institutional continuity. Some of his plans would also be extremely disruptive if implemented; the proposed expulsion of millions of undocumented immigrants, for example, could cripple entire industries. In the worst case, the US could face a sharp slowdown in activity with prices surging again on tariffs and supply issues. The Fed is therefore likely to remain cautious until the new administration's economic program is fully understood.

Europe slows again

The latest survey data point to a renewed deceleration in the eurozone and a growing risk of another recession in Germany. Both structural and cyclical forces have cut short yet another recovery in Europe and the continent appears to be stuck in stagnation. As inflation has also decelerated significantly, the ECB may be ready to accelerate the current pace of quarterly rate cuts.

China ups support

As if taking a cue from the Fed, late in September the People's Bank of China announced wide-ranging policy measures to prop up sluggish growth. The Chinese government has also announced more aggressive steps in support of the ailing property sector. Finally, facilities have been put in place to help the stock market in an attempt to shore up overall confidence. While these are steps in the right direction, it remains to be seen whether they will suffice to lift economic growth more sustainably.

Table 1: Real GDP growth (y/y in %)

	2024F	2025F	2026F	Short-term trend
United States	2.6	1.8	2.0	↘
Eurozone	0.7	1.3	1.5	↘
Germany	0.1	1.0	1.3	↘
United Kingdom	1.1	1.4	1.5	→
Japan	0.0	1.2	0.9	↘
China	4.8	4.5	4.2	↗
India	6.9	6.9	6.6	→
Russia	3.4	1.6	1.3	↘
Brazil	2.8	2.0	2.2	↘

Table 2: Consumer price inflation (y/y in %)

	2024F	2025F	2026F	Short-term trend
United States	2.9	2.2	2.3	↘
Eurozone	2.4	2.1	2.0	↘
Germany	2.4	2.1	2.0	↘
United Kingdom	2.6	2.4	2.0	→
Japan	2.5	2.0	1.6	↘
China	0.5	1.4	1.6	↗
India	4.5	4.5	4.4	↘
Russia	7.6	5.4	4.2	↗
Brazil	4.3	3.7	3.6	↘

Source: Bloomberg, HBZ

INVESTMENT STRATEGY

Managing with lower rates

The ongoing global easing cycle has many ramifications across asset classes. Money market returns in particular will decline, forcing investors to reassess their return expectations and risk appetite. No one should step out of their comfort zone, but most portfolios have room for diversification.

Key points

- Time to move further out the yield curve
- Equities should be part of any multi-asset portfolio
- Watch the US elections for market-moving outcomes

Building robust portfolios

The past two years were rewarding times for investors hugging the front end of the yield curve: Why take economic risks when you could earn a decent keep by keeping duration short? These circumstances are now changing rapidly, and investors need to consider other investments to meet their target returns. The first steps should be to lengthen the maturity of investments, in other words adding duration. This allows investors to lock in attractive rates for longer while reducing reinvestment risks. Yes, prices for longer-dated instruments are more volatile, but downside risks are low for buyers of quality (investment-grade) bonds, and even more so for hold-to-maturity investors. For investors with longer investment horizons, diversification into other asset classes and strategies is another sensible approach. In the long run, equities will deliver the highest returns among public market assets, and for that reason alone have their place in well-diversified portfolios. However, equities also tend to contribute the lion's share of market risk to such portfolios. Managing equity risk is therefore key. The derivatives market provides a vast toolkit to this end. Even better are strategies that incorporate such elements as part of their investment approach.

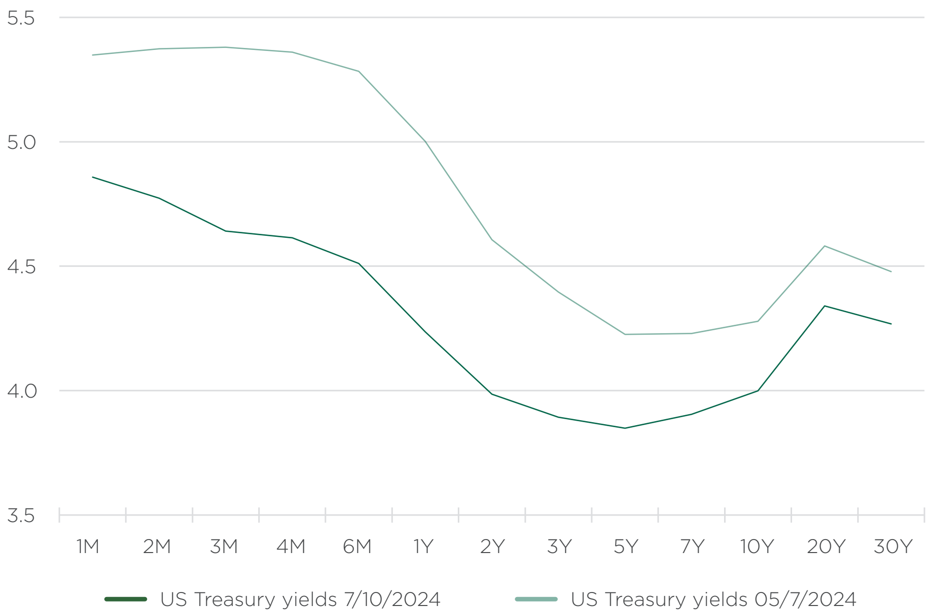
Our positioning

Over the past quarter, we lengthened the duration moderately in our multi-asset strategies by increasing our allocation to US Treasuries. In turn, we reduced our equity allocation and gave it a slightly more defensive tilt by adding consumer staples. Overall, we maintain a well-diversified stance aligned with our house view of lower inflation and lower growth in most major economic regions. Gold remains our favored hedge against the risks of further USD weakness and unforeseen geopolitical developments.

What we are watching

The US presidential elections are the main event to watch this quarter, since the outcome will affect investors one way or the other. Meanwhile, monetary policy decisions across the world will continue to shape markets. Against the global trend, the Bank of Japan could tighten policy further, which would impact the dollar/yen rate in particular. As every quarter, we will watch corporate quarterly reports for important trends in earnings and revenues. Will results continue to beat expectations?

Normalizing US yields force investor to take duration risks (% p.a.)



Source: Bloomberg, HBZ

FIXED INCOME

A bond-friendly world

With inflation lower and growth slowing, the economic environment should lend support to investment-grade bonds first and foremost. Emerging market (EM) issuers should benefit from Chinese stimulus measures but only to an extent. Selection remains key.

Key points

- Maintain carry strategies
- Focus on idiosyncratic risks
- Intermediate duration preferred

Investment grade: the value of peace of mind

The outlook for high-grade credits in the coming months remains favorable, thanks to demand for high-quality assets and relative stability despite a slowdown in global growth. The outcome of the US elections will invariably impact debt issuers, regardless of whether Kamala Harris or Donald Trump leads the next administration. Both scenarios offer potential benefits: Harris will not move much from the current status quo, which will provide a high degree of predictability, while Trump's focus on deregulation and lower taxes could enhance corporate profitability. Even amid more protectionist trade policies, high-grade companies are well positioned to adapt, particularly in industries supported by government priorities. Both candidates will pursue regulatory changes in different industries and hence affect issuers to different degrees. Those with strong balance sheets should benefit under most circumstances. As central bank rates are expected to decline further, improving refinancing conditions, the overall environment should remain favorable for investment-grade bonds with intermediate duration. With no recession in sight, investors need not worry unduly and can continue clipping coupons.

Emerging markets: China and the rest

The potential effects of China's recent stimulus measures on emerging markets and the global economy have become a major point of discussion among investors. While the stimulus may boost market sentiment, its real economic impact is expected to be limited unless supplemented by more comprehensive fiscal measures. Nevertheless, China's actions offer some relief, in particular for the commodity sector, especially metals. Generally, these measures provide support for EM bonds, including high-yield credits, and we suggest a switch into Chinese high-yield proxy plays such as commodity-heavy African issuers. The outlook may be more challenging for oil producers, as they could face renewed crosswinds from Saudi Arabia's shift in pricing strategy. Amid the renewed tensions in the Middle East, near-term debt issues from the region could face higher volatility despite generally healthy funding positions. Meanwhile, Mexico's political transition under its newly-elected president Sheinbaum makes us more optimistic about this credit. Overall, we prefer to focus on commodity-linked issuers and issues while remaining selective when it comes to the allocation of individual bonds.

US corporate bonds yields close to historical average

Source: Bloomberg, HBZ

EQUITIES

How to navigate the late-stage business cycle

All good things must eventually come to an end, including the current business cycle. This typically introduces a period of heightened volatility as markets toggle between repricing the growth outlook and changes in monetary and fiscal policies. How should investors position themselves?

Key points

- Business cycle is maturing
- Volatility typically increases during this stage
- Defensive and rate-sensitive stocks should benefit in this environment

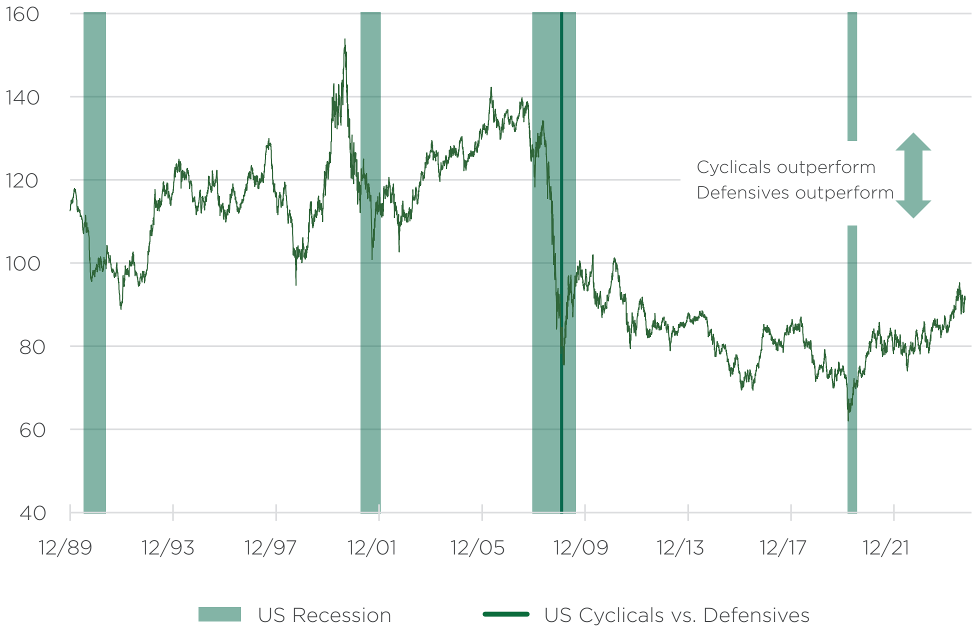
Of summer volatility and sector rotation

Similar to last year, July saw a market peak followed by a steep decline into the following month. This time around it was a combination of seasonally low market liquidity coupled with a spell of weaker economic data, including US labor market numbers, that prompted investors to recalibrate their risk appetite. In periods of low trading volumes, automated short-term trading tends to exaggerate market moves further, leading to violent swings. The unwinding of the yen carry trade, in other words borrowing in JPY and investing in higher-yielding paper such as USD-denominated assets or Japanese equities, added to market volatility as large flows were shifted when the Bank of Japan increased its benchmark rate and outlined plans to dial back on its bond purchases. Some investors were forced to sell assets – from US technology and real estate to EM stocks – to cover leveraged positions as interest rates rose and the yen appreciated. Given the widespread popularity of this trade, the market moves were massive, causing Japanese equities to drop 20% within a few days only to stage a major rebound. The volatility and change in investors' risk tolerance caused defensive sectors such as consumer staples, healthcare, and utilities to outperform, while more cyclical sectors such as consumer discretionary and energy underperformed. The defensive rotation reversed when the Federal Reserve announced a 50 bps rate cut, triggering a rally in cyclical sectors. This move was further accentuated by China's stimulus measures, which prompted a rally in European stocks reflecting the anticipated stimulus to growth.

One cycle ends, another begins

Going forward, we expect investors to focus more on the growth narrative than the inflation story, as inflation appears to be contained while growth will likely slow. Rate cuts in combination with lower business activity and softer labor markets suggest that we are in the late stage of the business cycle, a phase during which defensive and rate-sensitive sectors such as consumer staples, healthcare, utilities, and real estate tend to outperform. Eventually, however, once growth starts to pick up again on the back of accommodative monetary policies and perhaps also supportive fiscal policies, cyclical sectors and styles (smaller companies, weaker balance sheets, and value stocks) should be able to play out their strengths once again.

Defensive sectors outperfrom during economic slowdowns



Source: Bloomberg, HBZ

COMMODITIES AND FX

USD weaker but by how much?

The trade-weighted US dollar peaked in 2022 and then lost more than 10% within three months. Since then, the currency has been trading sideways. The start of the Fed's easing cycle could trigger another down leg, but the path to a weaker dollar seems not so straightforward.

Key points

- USD to weaken but not universally so
- Drivers of higher gold price remain in place
- Better to trade than to own crude oil

As carry goes, so goes the USD?

The larger-than-expected Fed rate cut in September could herald another leg down for the US dollar. Its carry advantage is set to decline rapidly, as the Fed will continue to ease into 2025 and possibly beyond. However, the US central bank is not alone in cutting interest rates, and this may limit the downside for the greenback against other majors, particularly the EUR and even the GBP. The Japanese yen is a different story, as the currency is not only cheaply valued by most measures, but the Bank of Japan is poised to raise its policy rate against the global trend over the coming quarters. Not surprisingly, the USD/JPY rate moved by more than ten points after the yen crested in July, while the trade-weighted USD lost only 4.5%. So, the expected dollar weakness could well feel different depending on the currency. For our part, we see more downside against the JPY than European majors. Once again, the EUR looks particularly vulnerable, with the common currency struggling with multiple structural and cyclical challenges.

No stopping for gold

Gold has rallied more than 28% so far this year and nothing seems to be able to stop this run. Having breached USD 2,600/oz. with relative ease, more upside is likely. After all, the drivers that have propelled gold to these levels are still in place: lower interest rates, a weaker US dollar, and the need for many central banks, especially those in emerging markets, to diversify and de-dollarize their balance sheets. Investors should just keep in mind that gold is a volatile asset, so setbacks can be quite violent.

Crude oil stuck in a range

Muted global growth and relatively ample supply have kept crude oil (Brent) trading in the mid-70s for most of the year. While oil, and indeed fossil fuels in general, will remain the core of the global energy mix, marginal demand has migrated to renewables, including nuclear, which is staging a quiet comeback. OPEC tried – and failed – to anchor crude oil prices at higher levels by voluntarily limiting the cartel's output. More recently, though, Saudi Arabia has changed course, indicating that it will seek to defend its market share. This will invariably translate into increased Saudi supply to global markets. Apart from periods of heightened geopolitical tensions in the Middle East, this development suggests that crude prices will remain subdued for longer. We therefore prefer to trade rather than own the asset.

JPY with more room for apprecation

Source: Bloomberg, HBZ

KEY MARKETS
Loosening under way

With inflation rolling over, our key markets have shown resilience as they brave their respective challenges. Pakistan has bridged its funding gap, at least for now, the UAE has been reaping the fruits of its non-oil sector, and the UK has found its way back to average growth.

Key points
- IMF program fuels investor confidence in Pakistan
- UAE sustains growth on strong non-oil sector
- Bank of England to ease further

Pakistan: tailwinds from the IMF and State Bank

As inflation continued to decline – in August consumer price inflation fell below 10% for the first time since October 2021 – the State Bank of Pakistan delivered another substantial rate cut, bringing the policy rate to 17.50%. More cuts are expected near term and the policy rate could fall to the mid to low teens by late 2025. Meanwhile, economic activity continued to pick up, aided by lower funding costs and government development spending. The backbone of the current recovery is a new IMF agreement negotiated in July aimed at creating the conditions for longer-term macroeconomic stability. Fiscal consolidation is a key element in this latest IMF program designed to extend tax collection, and will also limit the government's ability to unduly stimulate the economy, which in the past contributed to destabilizing boom-and-bust cycles. Key challenges remain high debt service payments and limited foreign currency reserves. Out of the USD 26 billion of debt payments due in the current fiscal year, some 40% still require refinancing or repayment. Provided the current account deficit remains in check and remittances sustain their current pace, this should be manageable. The improving economic backdrop and better sentiment should limit the downside for the PKR and continue to lift the stock market.

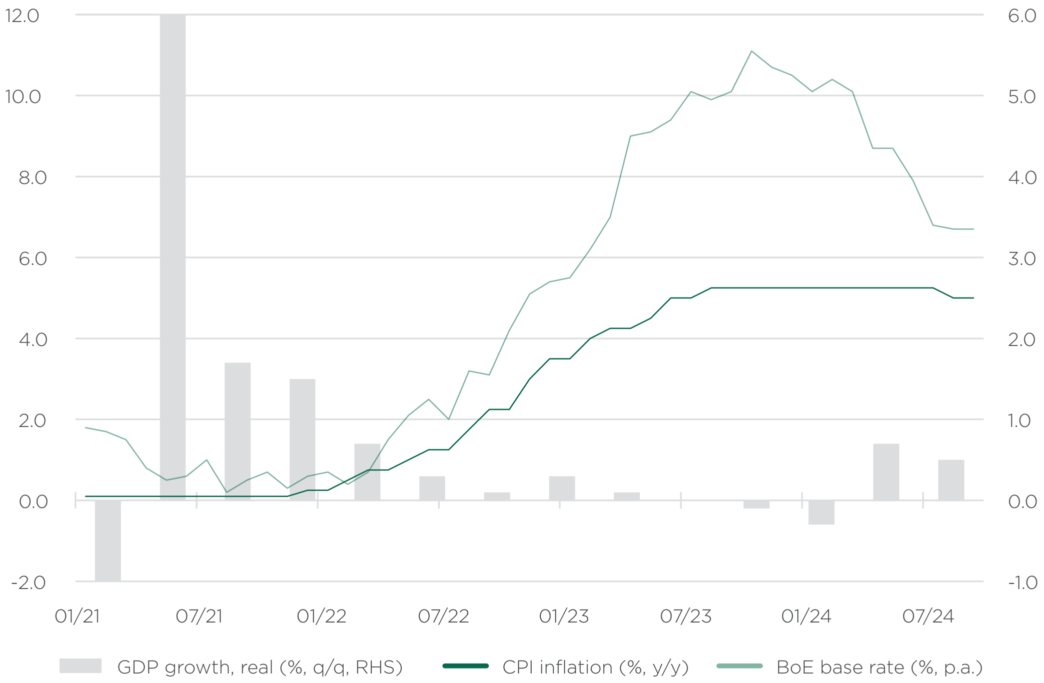
UAE: reduced dependency on oil

The latest PMI surveys for the UAE perked up again following a series of weaker readings. Overall, the outlook remains robust with growth expected to come in slightly above last year's, led by the rapidly expanding non-oil sector. The oil sector meanwhile remains constrained by OPEC output caps and lackluster global demand. Prices for UAE oil dropped to the low 70s before escalating regional tensions lifted them again. Lower Fed rates will improve lending conditions, which should benefit the property sector in particular.

UK: normalizing inflation, growth, and rates

The Bank of England (BoE) proceeded with the much-expected first rate cut in August. Inflation should eventually move towards the BoE's target of 2%, creating room for more easing. Economic data suggest that the catch-up from last year's recession will soon have run its course, bringing growth back to trend. In October the new government will present its first budget, which may contain an increase in capital gains tax but cap corporate tax at 25%. The GBP should provide some upside on a weaker USD.

UK key economic indicators are normalizing



Source: Bloomberg, HBZ

SPECIAL TOPIC
China on the mend?

After much hesitation and many piecemeal actions, the Chinese authorities finally adopted a comprehensive set of measures in late September to stop the rot in the property sector and prevent the economy from slipping back into deflation. Will this be enough or is there more to come?

Key points
- Monetary actions show government's sense of urgency
- Massive fiscal stimulus still needed
- Fiscal measures could lift Chinese equities further

Aggressive and comprehensive

For some time, the Chinese authorities looked reluctant to deal with the woes of the property sector in more than a piecemeal manner. However, as highlighted by the relentless drop in local market interest rates, Chinese economic agents, from households to corporates, were unconvinced that these numerous targeted measures would end the decline in house prices and prevent the return of deflation. Finally, the People's Bank of China (PBoC) announced more far-reaching monetary measures such as lower reserve requirements for banks' short-term rates, CNY 1 trillion in additional liquidity, and more capital for state banks. Moreover, mortgage rates were cut and down payments for housing purchases were reduced, while financing was provided for local governments to buy unsold homes. Finally, the PBoC put in place swap facilities to encourage stock purchases. The mood changed immediately and the Chinese stock markets soared.

No fiscal "bazooka" yet

While shortly thereafter the party leadership stressed its commitment to active fiscal measures, no large budgetary moves were announced (although in China the lines between monetary and fiscal policy are quite blurred). Markets actually expect more, much more. There is talk of a fiscal package of up to CNY 10 trillion (some USD 1.4 trillion) to address the excess in housing inventory, shore up local government finances, and support consumption. Such stimulus, together with additional monetary easing, would be a game changer for the economy, potentially lifting growth by 1 percentage point or more in 2025.

Structural challenges remain

Only time will tell whether the current and prospective measures are a turning point. The fact is that none of them can solve China's demographic challenges or correct years, if not decades, of misallocation of capital. The mood may have improved but could darken yet again if the economic recovery turns out to be short-lived. The very growth model needs to change. Although the government conceded this, its obsession with control and preference for investments over consumption simply further entrench the structural imbalances. Foreign capital, meanwhile, remains concerned about the ongoing tensions with the US and is unlikely to embrace the China story ever again with the same enthusiasm as two decades ago.

China attempts to put floor under property prices

Source: Bloomberg, HBZ

MARKET SUMMARY DATA

As of 7 October 2024

Equity indices	Last	-3M %	YTD %	-3Y %
BBG World USD	1,975.5	4.5	18.6	26.6
S&P 500	5,751.1	3.3	20.6	30.7
EuroStoxx 50	4,957.4	-0.4	9.6	21.0
FTSE 100	8,318.8	1.4	7.6	17.5
SMI	12,008.4	0.0	7.8	2.1
Nikkei	39,332.7	-3.6	17.5	40.2
BBG EM USD	1,318.1	9.3	17.9	1.5
Sensex 30	81,050.0	1.4	12.2	35.0
KSE 100	84,970.1	5.3	36.2	91.0
Hang Seng	23,099.8	31.8	35.5	-7.0
Brazil Bovespa	131,791.6	4.4	-1.8	19.2

Bond indices	Last	-3M %	YTD %	-36M %
FTSE US Gov	1,573.65	3.0	2.8	-5.6
FTSE US Corp	2,547.05	4.0	4.5	-3.8
FTSE US HY	1,356.92	5.0	8.1	10.2
FTSE Euro gov	222.11	3.1	1.7	-11.6
FTSE Euro Corp	245.74	2.7	3.6	-4.2
FTSE EM Sov	930.46	5.6	8.7	-0.3
DB EM Local USD	169.66	5.5	2.2	0.9

Currencies vs. USD	Last	-3M %	YTD %	-3Y %
DXY	102.52	-2.3	1.2	8.8
EUR	1.10	1.4	-0.5	-5.0
CHF	0.86	4.9	-1.6	8.6
GBP	1.31	2.1	2.8	-3.9
JPY	148.70	8.4	-4.9	-24.7
AUD	0.68	0.8	-0.3	-7.1
CAD	1.36	0.4	-2.5	-7.5
ZAR	17.49	4.1	5.6	-14.0
INR	83.97	-0.6	-0.9	-10.9
PKR	277.64	0.3	1.4	-38.5
Gold oz.	2,653.60	11.2	28.9	51.3

Interest rates	3M interbank %	10Y government %
USD	4.85	4.00
EUR	3.25	2.25
GBP	5.30	4.19
CHF	0.87	0.46
JPY	0.26	0.93
AUD	4.42	4.07
CAD	4.97	3.24
ZAR	8.04	10.48

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