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INVESTMENT OUTLOOK 03.2024

15 July 2024

In the second quarter risky assets continued to rally, albeit at a slower pace. At the same time, government bonds experienced losses since central banks disappointed rate cut expectations. Although the ECB cut its policy rates by 0.25%-points in June, it dampened expectations for additional rate cuts in the near future.

In our view, more and more indicators clearly show that US economic growth is slowing, which leads us to believe that we are nearing a recession, most likely within the next 6 to 12 months. However, it seems that most market participants do not agree with our view and rather anticipate a soft landing for the US economy. The narrative “bad news is good news” dominates market reactions to softer economic data. We, however, believe that eventually, if a recession happens, a market correction will be inevitable.

As a result, our portfolios are positioned cautiously, with equities, REITs, high-yield bonds, and commodities underweight. At the same time, we are overweight cash and nominal government bonds.

Trauth

Thomas Trauth
CEO – IMT Asset Management AG

WILL NVIDIA BE ABLE TO MEET EXPECTATIONS?

Financial Markets

The persisting very strong influence of the technology stocks was a major factor in the positive second-quarter stock market development. The S&P 500 Index bounded from one record high to the next, increasing 3.9% in Q2. Nvidia alone accounted for about a third of the index's first half-year performance. For a period in June Nvidia was the company with the highest market capitalization worldwide. The NASDAQ Index surged 8.3%, and emerging markets equities rose by 4.2%. In Contrast, the MSCI Europe remained flat and the Nikkei 225 even lost 1.9%. Volatility (option prices) remained at historically low levels.

Since inflation remained stubbornly above the central banks' targets in the second quarter, the US Fed refrained from lowering interest rates. In contrast the ECB reduced interest rates by 0.25 percentage points in June. Because of the continuing restrictive monetary policy, government bonds fell slightly in value in the second quarter. Emerging market bonds denominated in local currencies were also hit by losses. By contrast high-yield bonds and insurance-linked bonds gained in value. After the announcement of snap elections in France, French government bond yields increased sharply, as concerns about rising public debt emerged.

The broad commodity price index rose slightly in the second quarter, with the biggest increases registered in industrial and precious metals, especially silver. The EUR tended rather towards weakness in the second quarter, losing slightly against the USD, GBP and CHF. Due to the Bank of Japan's ongoing expansive monetary policy the JPY continued to lose value.

The price of Gold climbed by 4.3% in Q2, outpaced by silver, which gained 16.7%. The price of brent oil fell by 1.2%, as contagion risk in the middle-east seems to have subsided for the present. Brent oil is trading at around 85 USD/bl currently.

REITs lost value in Q2, as high interest rates continued to weigh on the property market.

Crypto assets fell sharply in June, driven by the liquidation of derivatives positions and strong outflows out of Bitcoin ETFs. Between end of May and July 5, Bitcoin fell 16.7% and Ethereum 21.5%.

The EUR-USD exchange rate remains range-bound, between 1.05 and 1.10. The JPY continued to weaken in Q2 due to very low interest rates and despite some market interventions from the Bank of Japan. Only in recent days has the JPY recovered somewhat. The Chinese CNY remained soft due to China's weak economy. The CHF, after weakening in Q1, recovered in Q2.

Macroeconomics

There are increasing signs that the US economy is starting to slow down. The restrictive monetary policy of the past 2.5 years is beginning to have its effect. There have recently been significant declines in retail sales, investment intentions and housing starts. There is growing evidence that private excess savings, accumulated during the pandemic, have been used up. This is also apparent in the fact that credit card and consumer debt delinquencies are clearly on the increase. In addition, US unemployment has risen from 3.4% in April 2023 to currently 4.1%. We therefore expect the USA to go into recession in the course of the next 6 to 12 months.

The economic downturn is consistent with a further drop in inflation. European inflation has stabilized at about 2.5%, but remains above the ECB's target of 2%. In June US inflation fell distinctly from 3.3% to 3.0%.

Central Banks

In June the ECB cut its benchmark deposit rate to 3.75% from 4.0%, and the SNB its benchmark rate to 1.25% form 1.5%. ECB president Christine Lagarde signaled, however, that further rate cuts are data dependent and, thus, unlikely to happen soon. Currently the market is pricing in an 85% rate cut probability for September.

Meanwhile, the US Fed kept rates steady at 5.5%. Rate-cut expectations rose, however, especially after the soft inflation figure in June, and currently imply a 95% probability for a 25 basis point cut in September.

The Bank of Japan has become increasingly uncomfortable with the weakening JPY. The JPY fell to a 34-year low as interest rates differentials remained very wide for an extended period of time.

As a result, the Bank of Japan is expected to tighten monetary policy. It already increased its benchmark interest rate slightly and intervened on the currency markets to support the JPY. Recently, it also surprised markets by buying smaller amounts of government debt. As a result, 10-year government bond yields rose above 1% for the first time in 11 years.

Private Markets

On the back of tighter monetary conditions, the performance of private market funds was clearly impacted negatively. Global venture funds were flat during the last three years (pooled trailing net returns) vs. almost 16% during the last ten years. Also, global buyout funds delivered only about 11% over the last three years vs. 14% over the last ten years.

Deal activity, which dropped tremendously after 2021 gained strong momentum in the second quarter and doubled compared to the first quarter. This recovery was broad based and included a number of very sizable LBOs. Venture capital was unable to benefit from this development. It seems that many mutual funds and sovereign wealth funds have decided to avoid venture investments for now.

Exit activities remain subdued, however. Deal volume during the first half of 2024 was USD 126 bn, which was only slightly higher than in the first half of 2020 during the outbreak of the pandemic. As a result, the average holding period of portfolio companies clearly increased beyond the typical 4-5 years. Currently 18% of the companies are held between 5-7 years and 12% even longer.

Another consequence of this development is a continued shortfall of distributions. We are now in the eighth consecutive quarter of negative net distributions. This certainly partly explains why raising capital for new funds has recently proven so challenging.

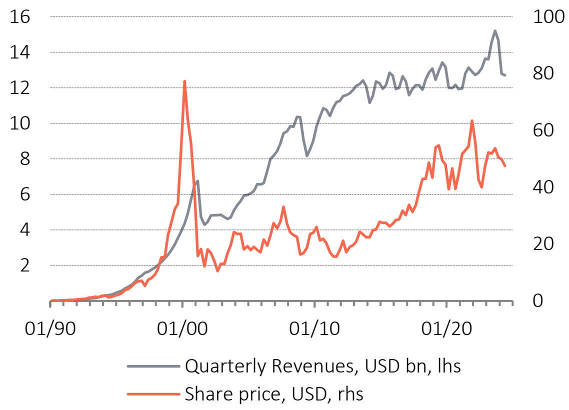
The source for this section and the mentioned data is: "Global Private Markets Quarterly, Q3 2024" by Peter Cornelius of AlpInvest, which is part of Carlyle Group.

Nvidia

Nvidia is without doubt a great company and a clear market leader for high-performance chips, which are essential for generative AI systems. The NVIDA stock outperformed the S&P500 this year by 135%. Its market capitalization currently stands at more than USD 3.1 tn, ranking closely behind Apple and Microsoft. In June it was briefly the most valuable listed company globally.

Garry Evans of BCA Research made an interesting comparison between Nvidia and Cisco Systems. Cisco Systems provides infrastructure for telecom networks, which is essential for all internet services, which started to emerge in the late 1990s. During the tech boom in 2000 Cisco also briefly became the largest listed company. When the tech bubble burst, Cisco's share price dropped by 80%. Since then Cisco has established and grown its market position very successfully. It has almost tripled its revenues. Nevertheless, its current share price remains 40% below its peak in 2000, as seen in the chart below.

Cisco Systems. Share price and revenues, since 1990



Source: Bloomberg

NVIDIA currently trades at a forward P/E ratio of 49. This implies first that the AI market will continue to grow at a neck-breaking pace and double again in the next couple of years, second that NVIDIA will be able to maintain its dominant market share, and third that it will keep its staggering operating profit margin of more than 50%. In our view, some of those assumptions look questionable. First, demand for ultra-expensive chips may sooner or later be saturated; the second point is that competitors like Intel and AMD are working hard to catch-up, and the third that NVIDIA's profit margins will eventually come under pressure.

Outlook

The financial markets are currently experiencing a boost from the decline in inflation and the expectation that the central banks will reduce interest rates in the second half of the year. At the same time, most market participants apparently remain convinced that the US economy is heading for a soft landing.

Apart from being aware of heightened business cycle risks, we are perturbed to see how strongly dependent the current stock markets are on just a few technology shares and high expectations for productivity gains through the deployment of artificial intelligence. We see a risk that this euphoria might cool down, in which case there could be far-reaching consequences for the global stock markets.

For the reasons set out above we are maintaining our defensive portfolio position. We are remaining underweight in equities, REITS, high-yield bonds and commodities. To profit from the more attractive interest-rate environment we have gone overweight in nominal government bonds.

In our opinion nominal bonds have an asymmetrical opportunity-risk profile. If, for example, returns on 10-year US bonds reached a new cycle peak of 5%, an investor would lose only 1% over 12 months. On the other hand, if the bond yield dropped to 2%, which is eminently possible in a recession, the overall return would be 22%.

Finally, we have reduced our insurance-linked bonds from overweight to neutral in order to limit natural catastrophe risks.

ECONOMICS

Purchasing managers' indices in major economies softened in June. Also, inflation declined, in the US to 3.0% from 3.3% and in the EMU to 2.5% from 2.6%. The US economy showed various signs of weakness: retail sales, investment intentions, and housing starts declined. Furthermore, US unemployment rose. Non-farm payrolls fell to 208,000 after 218,000. However, most jobs were created in acyclical sectors like government, health care, and social assistance. If such sectors were excluded job gains would be only half.

Fig. 1: PMIs

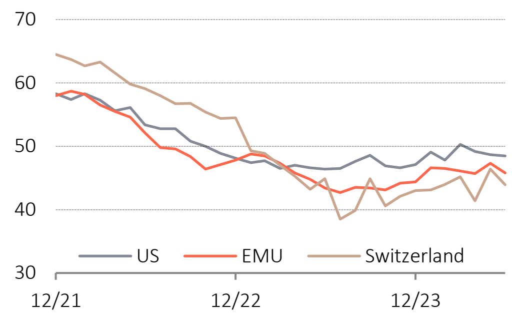


Fig. 2: PMIs

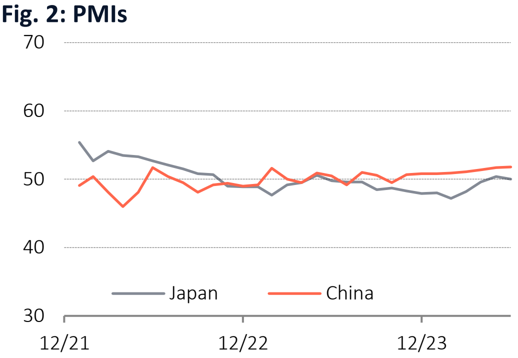


Fig 3: Consumer price inflation, in % YoY

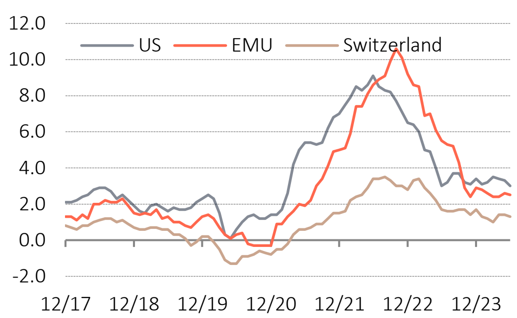


Fig. 4: Consumer price inflation, in % YoY

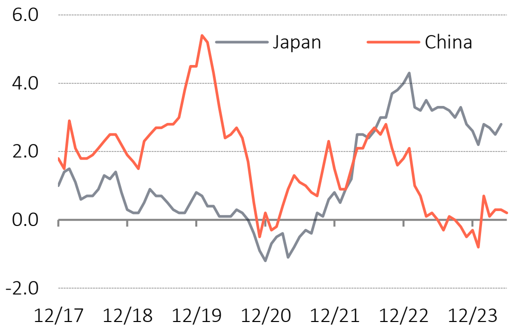


Fig 5: Unemployment rates, in %

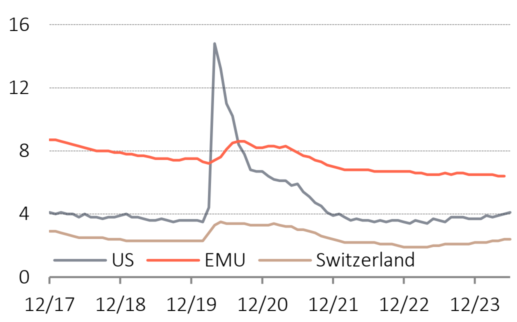
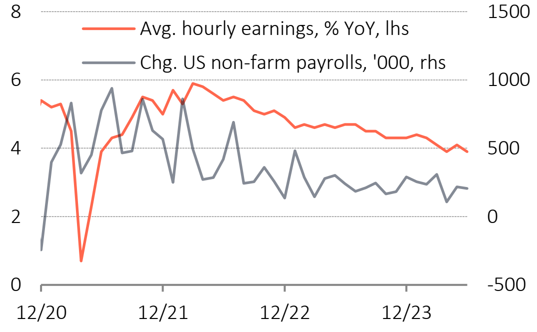


Fig 6: US labor market



FIXED INCOME

Despite a first rate cut by the ECB in June, central banks remained concerned about the inflation outlook, so that market participants had to push back rate-cut expectations. As a result, bond yields rose in Q2. 10-year bond yields increased by about 20 basis points in the US and Europe. After the announcement of snap elections in France, French government bond yields increased sharply, as concerns about rising public debt emerged. High-yield bonds, however, performed well in Q2.

Fig.7: 2Y government bond yields

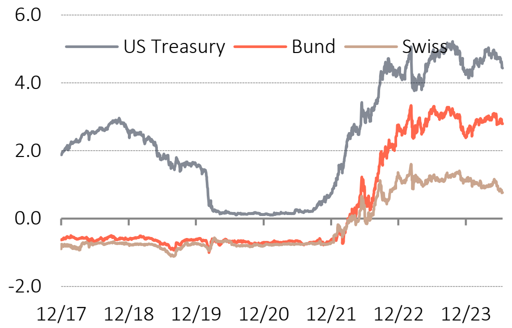


Fig. 8: 10Y government bond yields

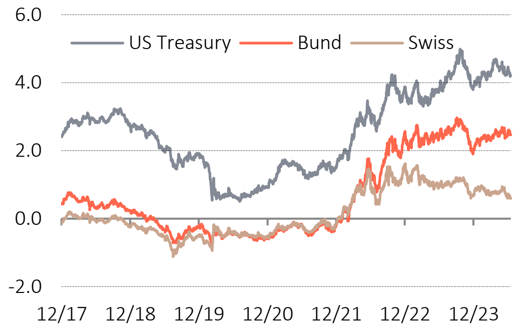


Fig 9: 10Y break-even inflation

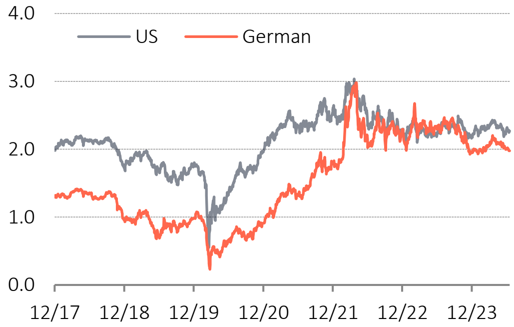


Fig. 10: Credit spreads, 5Y credit default swaps

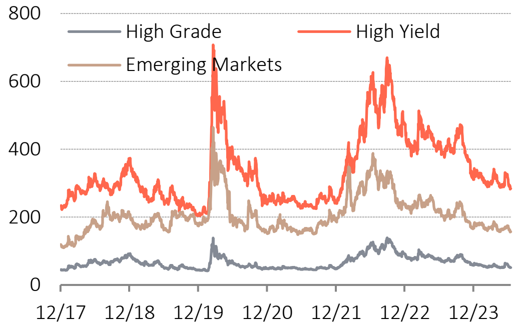


Fig 11: Money market spreads (3M-2Y)

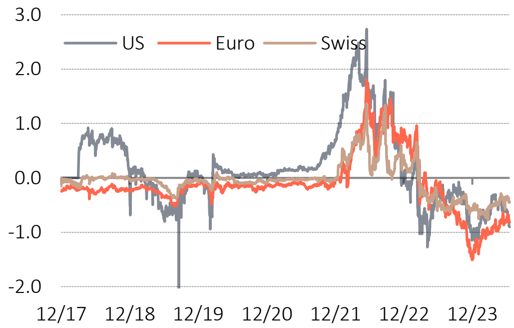
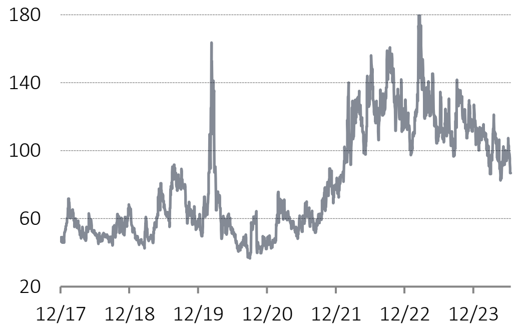


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

In Q2 the equity market rally slowed somewhat. Technology stocks continued to outperform. The NASDAQ Index surged 8.3%, S&P500 Index climbed 3.9%, and emerging markets equities rose by 4.2%. In Contrast, the MSCI Europe remained flat and the Nikkei 225 even lost 1.9%. Volatility (option prices) remained at historically low levels.

Fig. 13: MSCI equity indices – major regions

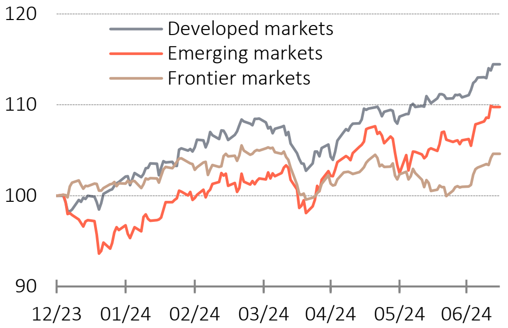


Fig.14: Equity indices – major developed markets

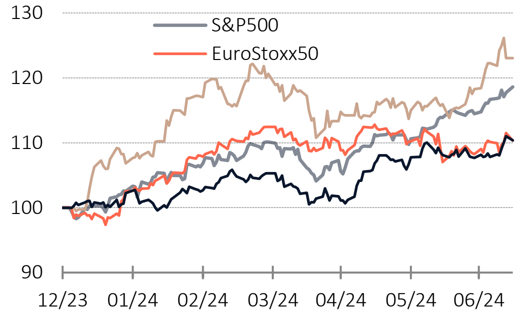


Fig 15: Equity indices – major emerging markets

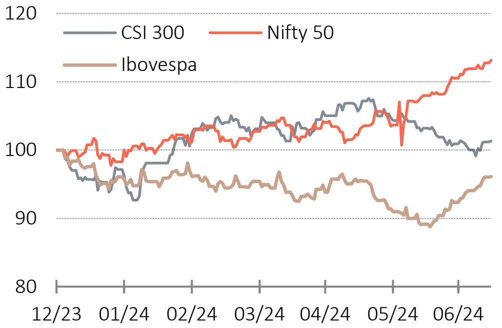


Fig. 16: Sector performance, MSCI Indices, 2022

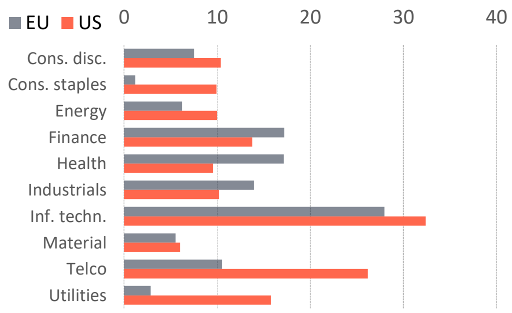


Fig 17: Price-earnings ratios

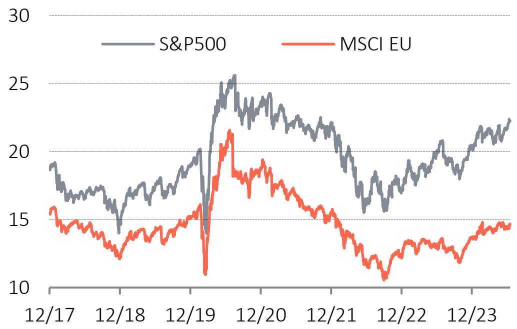
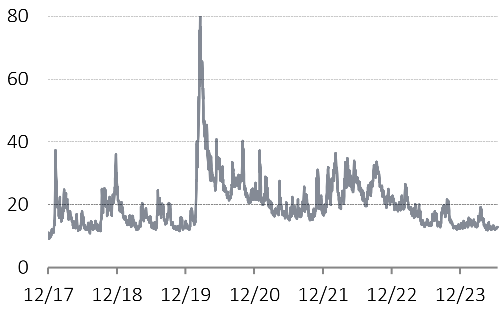


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

The price of Gold climbed by 4.3% in Q2, outpaced by silver, which gained 16.7%. The price of brent oil fell by 1.2%, as contagion risk in the middle-east seems to have subsided for the present. Brent oil is trading at around 85 USD/bl currently. REITs lost value in Q2, as high interest rates continued to weigh on the property market. Crypto assets fell sharply in June, driven by the liquidation of derivatives positions and strong outflows out of Bitcoin ETFs. Between end of May and July 5, Bitcoin fell 16.7% and Ethereum 21.5%.

Fig. 19: Gold price, USD/oz

Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

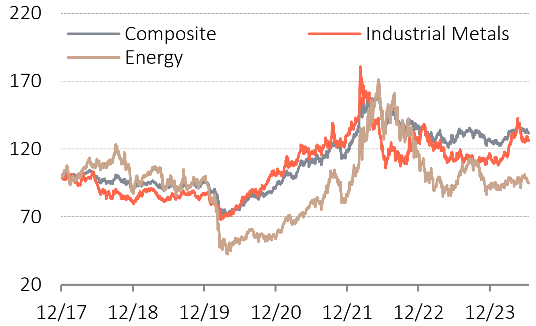


Fig. 22: Global Listed Private Equity

Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: Crypto Assets

CURRENCIES

The EUR-USD exchange rate remains range-bound, between 1.05 and 1.10. The JPY continued to weaken in Q2 due to very low interest rates and despite some market interventions from the Bank of Japan. Only in recent days has the JPY recovered somewhat. The Chinese CNY remained soft due to China's weak economy. The CHF, after weakening in Q1, recovered in Q2.

Fig. 25: EUR-USD exchange rate

Fig. 26: GBP-USD exchange rate

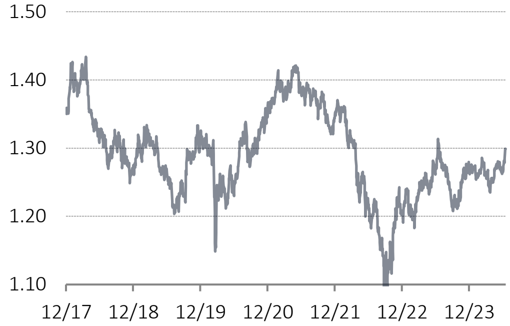
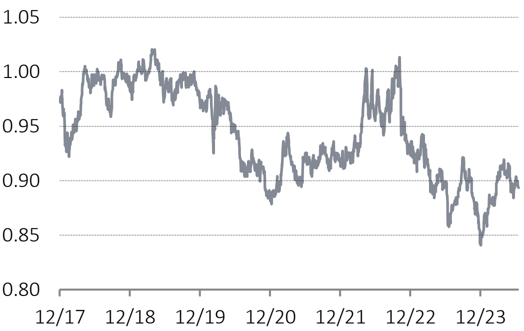


Fig 27: USD-JPY exchange rate

Fig. 28: USD-CNY exchange rate

Fig 29: EUR-CHF exchange rate

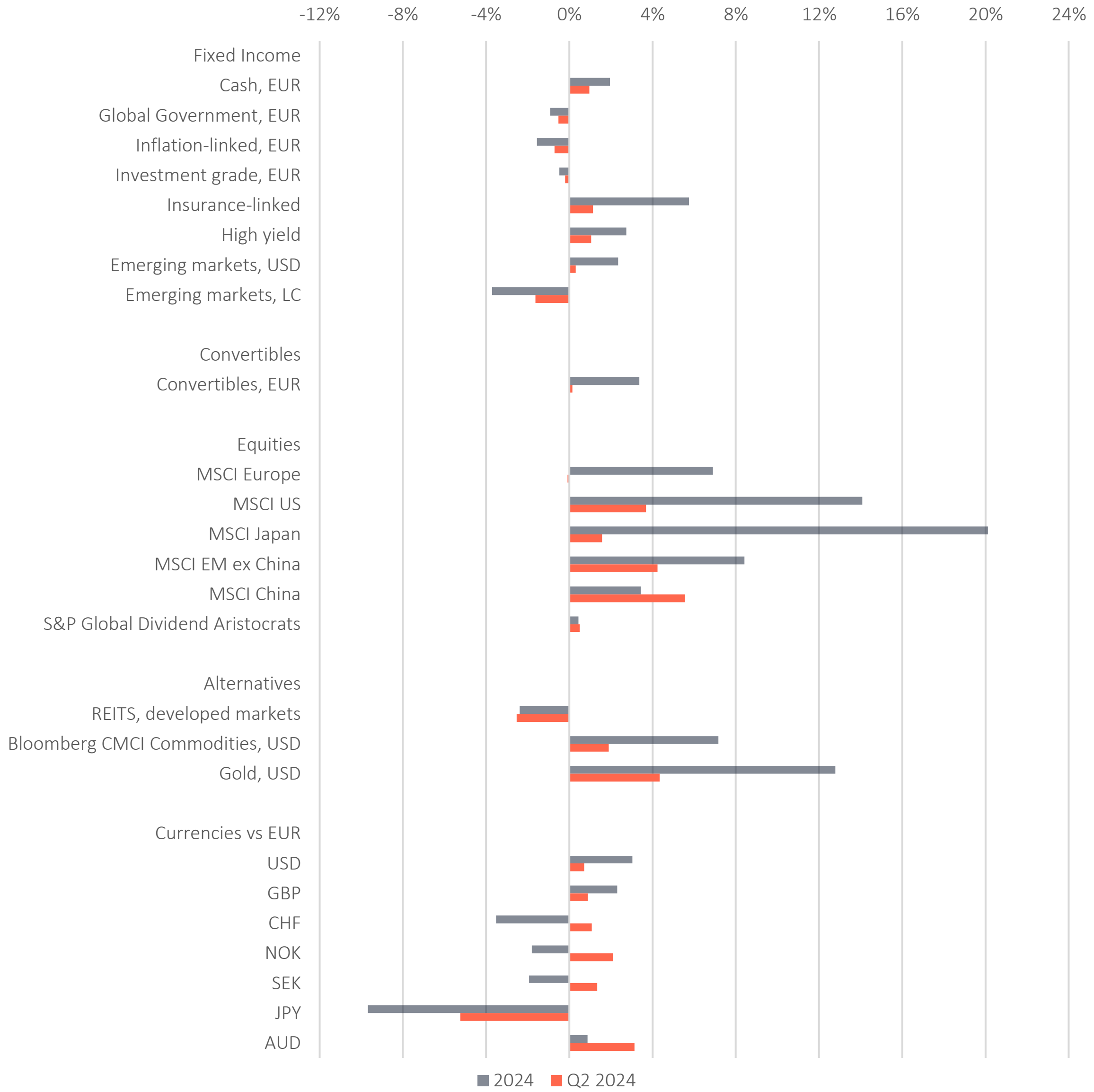
Fig 30: USD-CHF exchange rate



ASSET ALLOCATION

In Q2 risky assets continued to perform well, albeit rather less so compared to Q1. Especially Chinese stocks gained, while Global Dividend Aristocrats underperformed. Government bonds, including inflation-linkers lost some value due to disappointed rate-cut expectations. Meanwhile, high-yield bonds had a decent month. REITs still suffered from high interest rates. Commodities performed well, especially industrial and precious metals. The EUR weakened across the board in Q2. Only the JPY was even weaker and devalued against the EUR.

Fig. 31: Performance of major asset classes, based on our EUR portfolio strategy

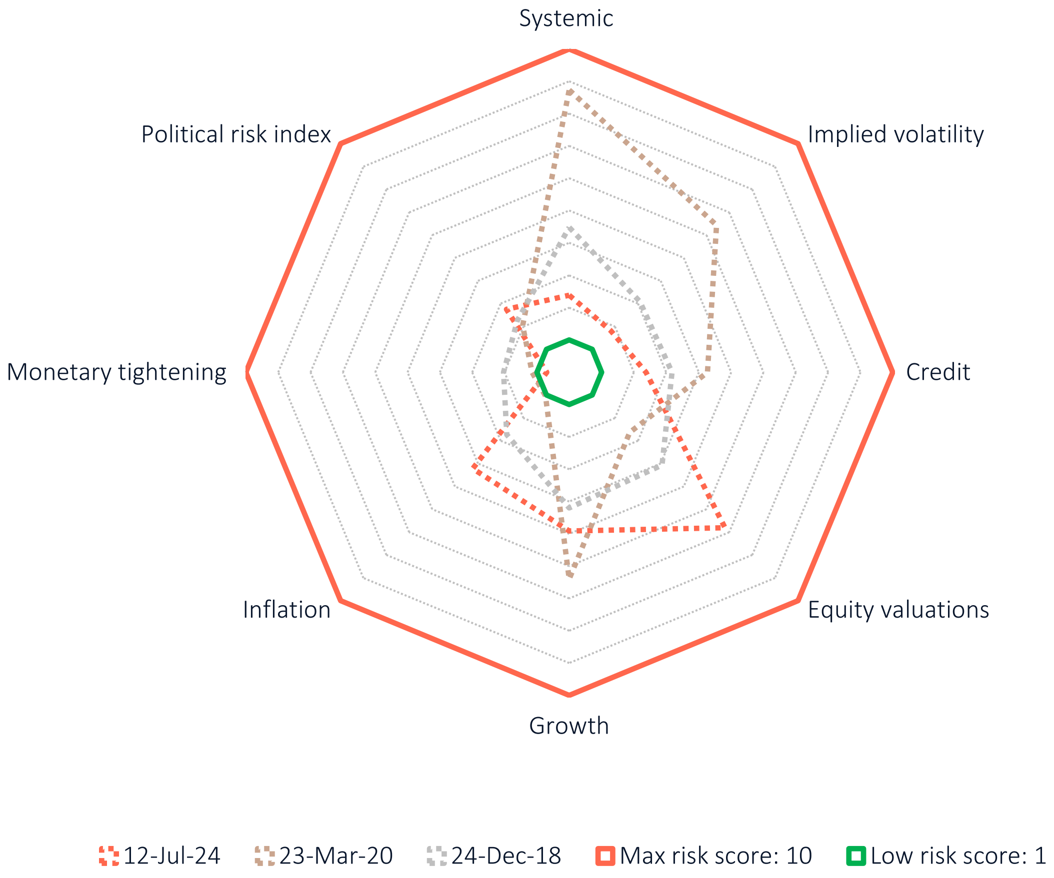


RISK MONITOR

The risk landscape has remained relatively stable in recent months. Inflation, growth, and equity valuation risks are elevated, while the chances of further monetary tightening are almost zero. Systemic (banking) and credit risks remain muted. Also, option prices are historically low, indicating that there is little demand for hedging.

Fig. 32: IMT Risk Monitor

24-Dec-2018: Growth and monetary tightening fears
23-Mar-2020: Global pandemic



DISCLAIMER

Source for all graphs: Bloomberg, IMT Asset Management AG.