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Our convictions for the end of 2024

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Crédit Mutuel
Asset Management

Introduction

François Rimeu

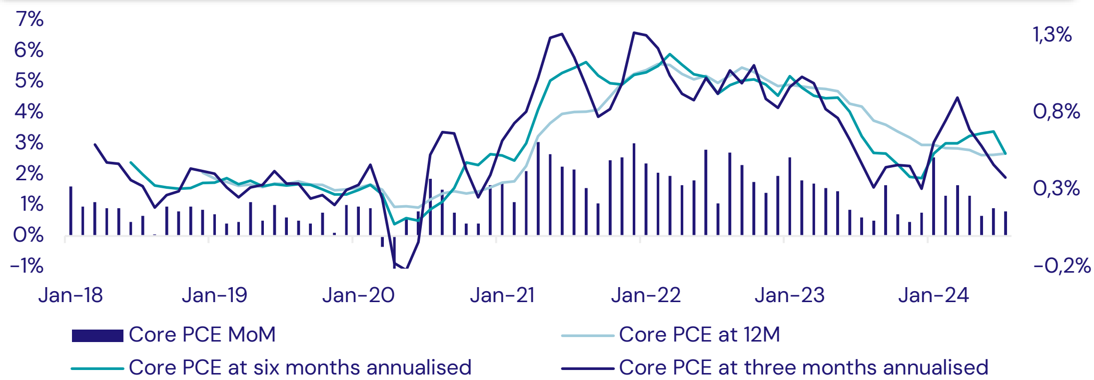
Senior Strategist, Crédit Mutuel Asset Management

In our view, the Fed has every reason to start dialing back its restrictive monetary policy, and ease monetary conditions

The Jackson Hole conference is now behind us and it marks both the end of the holiday season and the very likely start of the US Federal Reserve's rate-cutting cycle. Jerome Powell was very explicit, stating that "the direction was clear" and that "the time has come for policy to adjust".

This announcement makes sense in light of the summer we have just been through. The drop in the price of a barrel of Brent oil from $84 to $78 on 23 August signals a brighter outlook for short-term inflation. In addition, the inflation figures published over the last two months have been reassuring, very much so in the United States, even if this remains somewhat less the case in the eurozone.

US core inflation rate



Sources: Groupe La Française, Bloomberg as at 23/08/2024

The latest US employment figures were quite disappointing and in August even induced a (short-lived) episode of panic in a market that in truth was sorely lacking in depth. Hence, we see no reason for the Fed o refrain from gradually reducing the restrictive nature of its monetary policy.

Are these generally disappointing figures from the summer indicative of an imminent recession? We think not. The eurozone is slowing down after a slight improvement in the 1st half of the year, but keeping its head above water thanks to the services sectors. The slowdown is also real in the United States, but the economy is nevertheless expected to maintain nominal growth of around 4-5% in the coming quarters, a pace one could only dream of in Europe. There are no significant updates to report from China at this time.. The health of the exporting machine allows them to hope for growth close to 5% this year.

Financial markets are anticipating a fairly aggressive cycle of rate cut cycle, particularly in the United States, with four rate cuts by the end of 2024, and eight in the following 12 months. We believe these expectations are overly ambitious given the state of the US economy. After all, there are still uncertainties about the future of inflation in the medium term, not to mention the potential consequences of the elections in the United States. The situation is obviously less true in the eurozone, where there are greater difficulties in the economic environment.

Sovereign Debt

Traditionally, summers are generally known for a certain sense of calm: trading volumes fall, volatility fades, market participants take time off. However, this trend may not be as pronounced in the summer of 2024.

The Bank of Japan (BOJ) surprised the market by tightening monetary policy. Although the increase in key rates by 15 basis points (bps) to 0.25% was expected in the medium term, it was accompanied by a gradual reduction in the pace of sovereign bond purchases by the BOJ (halved to JPY 3,000 bn by the first quarter of 2026, from nearly JPY 6,000 bn in 2024).

Why is this so significant? Over the past few months, Japan has been experiencing rampant inflation and a weak yen, making it a perfect carry trade. Investors borrow a currency from a country with low yields, such as Japan, they sell that currency to buy dollars and invest them in assets like US Equities or Treasuries. The aim is to take advantage of the interest rate differential between an inexpensive loan and a more attractive investment. As interest rates rose, the yen appreciated, making this arbitrage much less profitable and even generating losses. Investors had to sell assets, particularly technology stocks, to unwind positions.

Meanwhile, concerns about the potential for a recession in the US economy have intensified. The employment figures published on 2 August were largely disappointing. In addition to weak job creation in July (114,000 vs. 175,000 expected), it was the historic rise in the unemployment rate (4.3% vs 4.1% expected) that particularly worried investors. The fear that monetary policy will contribute to an economic slowdown is reflected in the US 10-year yield, which declined by 50 bps in one week in a rapid steepening movement (+10 basis points on the 2Y-10Y). While the Federal Reserve (Fed) maintained its rates at its last meeting on 30-31 July, there were calls for an emergency cut. The risk-off movement spread to peripheral (and French) spreads while volatility has emerged as a key driver, with the VIX reaching highs over the period that have only been topped on two occasions: during the 2008 financial crisis and during the pandemic in March 2020.

While the most recent data indicate a slowdown in activity in the United States and thus are rekindling fears of a recession, we think that US growth is continuing to show a favourable trend, particularly consumption, which continues to support various factors (real wages in positive territory, excess savings not yet exhausted).

Investors' expectations regarding the easing of US monetary policy seem to us to be too aggressive (100 bps cut in key rates between now and the end of the year); they could gradually revise their expectations and initiate an upward recalibration (three cuts of 25 bps).

In this context, we are making few changes to our allocation. We remain neutral overall in terms of sensitivity and favour the short and intermediate zone of the euro curve as well as the issues of the core and semi-core European countries while remaining underweight on Italian and French debts. We favour Spanish and Portuguese treasuries.

Olivier Sayac, Head of Traditional Fixed Income

Sources: Groupe La Française, Bloomberg as at 23/08/2024

Investment Grade Credit

Year-to-date, Investment Grade (IG) credit posted a positive performance of 2.7% as of 23 August. The asset class benefited from attractive carry in a context of expectations of monetary policy easing on both sides of the Atlantic and resilient corporate earnings.

In this context, we are neutral on credit spreads as we believe carry and duration will be the main drivers of performance.

The US implicit rate fell from 5.2% on 31 May, to 4.3%, representing a 100 basis points (bps) cut in key rates, a significant shift from the 10 bps adjustment at the end of May. The new rate will be implemented over the next three Fed meetings, up until the end of the year.. This re-evaluation is driven by recession fears, rather than a "soft landing" of the economy or lower equilibrium rates. However, risk premiums on IG credit moved only slightly from the extremely low levels at the beginning of the summer: around 10 bps for both financials and corporates.

Disappointing results, particularly in the technology sector, and economic data pointing to a slowdown in the US economy pushed equities down and widened risk premiums in early August. However, IG risk premiums returned to levels close to the year's lows and movements remained moderate, especially taking into account deteriorated liquidity conditions, highlighting the resilience of the asset class.

We believe that the market's recalibration of the US economy is exaggerated. A controlled slowdown represents our central scenario. Consequently, risk premiums on IG credit are likely to remain stable and the spread differential between High Yield (HY) and IG, currently at a relatively low level (245 bps), is likely to deteriorate via a widening of the HY segment.

In addition, demand for IG credit remains strong. In the second quarter, IG funds posted positive inflows of €7.9 bn, putting 2024 on a record inflow (around €20 bn YTD). As primary issues were massively anticipated in the first half of the year, the main performance driver of this asset class does not seem to be running out of steam.

In terms of fundamentals, IG credit remains strong. Indeed, 88% of CAC 40 companies published their second quarter 2024 results, which are up 3% on average. On the other side of the Atlantic, 95% of S&P 500 companies also reported results, with an average increase of 5.2%. However, the number of companies improving their net income is down slightly compared to the historical average, with HY being the main cause of this decline.

This year will be marked by the optimisation of carry, ensuring that it remains defensive: We continue to favour quality and prefer defensive sectors over cyclical sectors, while paying close attention to sector dynamics.

Sources : Groupe La Française, Bloomberg as at 23/08/2024

Past performance is not necessarily a guide to future performance.

We favour the short and middle end of the curve, up to 5-7 years, over the long end, which allows us to maximise the roll down return for a moderate beta. We expect a decompression movement over the rest of the year and position ourselves accordingly, favouring IG ratings over HY. From a sectoral point of view, we favour financials over corporates because, although their valuation is less attractive than at the beginning of the year, fundamentals indicate that this segment is the preferred choice.

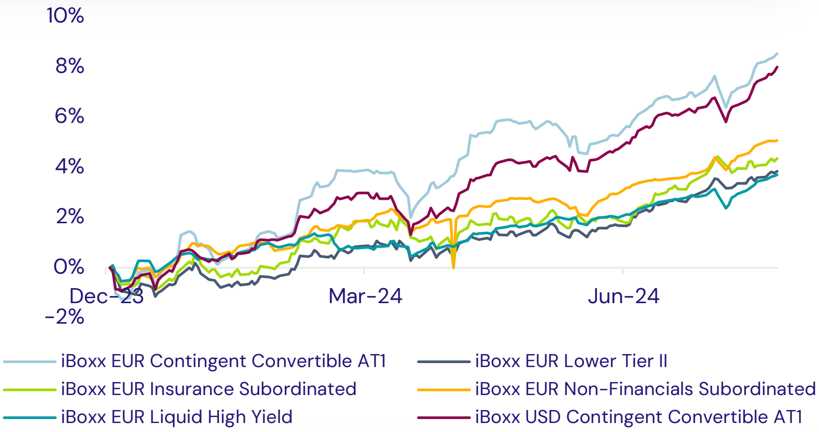
Olivier Sayac, Head of Traditional Fixed Income

Rates

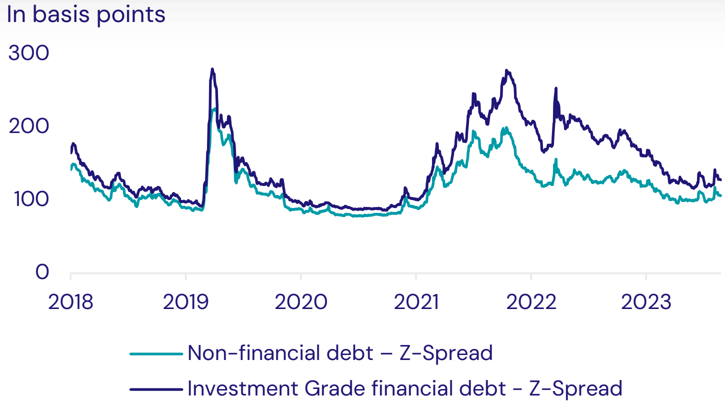
Subordinated debt

Interest in the credit market, and particularly in financial and subordinated debt, remains strong, despite a narrower valuation differential compared with non-financial IG and HY debts, following the strong rally since the beginning of 2024.

Change in the total return performance of a selection of subordinated debt and € High Yield indices in 2024



Change in the average Z-spread of Investment Grade financial debt versus non-financial debt



The shock of market volatility at the beginning of August probably did not alter investors' appetite, who continue to favour this portion of the credit market due to the more accommodating stance of central banks. The earnings season was good for European banks as a whole, and particularly for those in the "peripheral" region, which are largely continuing to improve their balance sheet health.

Lower risk premiums and coupons also enable issuers to refinance their securities under optimal conditions, with very strong demand for recent primary issues and with early redemption options exercised in all segments (excluding very specific cases such as the Austrian bank RBI, which is still present in Russia). The proliferation of buyback offers accompanying new issues well in advance of future refinancing (sometimes 10 to 15 months before the expected call date) has reduced the volatility of issues with maturities approaching, which has helped to steepen the risk premium curves somewhat.

In general, we expect a lower primary market in H2 2024 on bank debt compared to H1 2024, and in particular on senior debt, now that banks have largely refinanced TLTROs and built their bond liability buffers.

We therefore favour a carry-focused approach, given the strong tightening of risk premiums over the last 10 months and the still relatively low yield slopes overall.

This approach results in a preference for high-coupon AT1 CoCos, Tier 2 insurance and Corporate Hybrids in defensive sectors. We are becoming more cautious on Restricted Tier 1 insurance debts, as well as AT1 CoCos denominated in USD, which are historically expensive in terms of spread differential compared to AT1 CoCos in EUR, and US Tier 1 Preferred debts.

Jérémie Boudinet, Head of Financial and Subordinated Debt

Sources : Groupe La Française, Bloomberg as at 23/08/2024

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High Yield Credit

Year-to-date, the High Yield segment has shown significant resilience, posting a positive performance of 5.2% as of 23 August. In a context of monetary easing, the asset class continued to attract investor interest thanks to high carry and controlled default rates.

Coming into this autumn, there are three reasons why we must observe and maintain a certain degree of caution on High Yield risk premiums over the short to medium term (over a two-three month horizon):

- The slight deterioration in macroeconomic momentum is beginning to be noticeable in certain sectors, such as consumer discretionary and industrials.
- The unstable political situation in France in a budgetary, economic and social context that does not leave much room for manoeuvre.
- The US elections, scheduled for early November and which are likely to trigger an increase in market volatility (historically two months earlier).

All these factors are a source of volatility on the markets and are likely to push credit spreads further apart in the coming weeks. In addition, the relatively aggressive positioning of investors in risky assets (equities, credit and emerging markets) may exacerbate the move away from these assets.

From a geographical point of view, the US market is expected to outperform other markets for the rest of the year due to more favourable technical factors, a more accommodative Fed and less sensitivity to external geopolitical risks. In some respects, the election of Donald Trump could benefit the US credit market with more favourable regulation for the financial, energy and industrial sectors, which accounts for the bulk of the US HY universe.

On the other hand, retaining a Democratic candidate would not be a change from the current situation. For emerging markets, after a very good performance since the beginning of the year (-150 bps tightening in risk premiums), the trend could reverse in the last quarter of 2024 if Donald Trump comes to power, as this scenario is clearly unfavourable for emerging assets.

From a sectoral point of view, given the ongoing macroeconomic slowdown, we expect defensive sectors sensitive to falling interest rates (Healthcare, Services, TMT: Technologies – Media – Telecommunications, Utilities, etc.) to outperform more cyclical sectors that are more vulnerable to the resurgence of political risks, particularly in Europe.

Our scenario in terms of total performance of the High Yield credit market between now and the end of the year remains unchanged (vs our projections at the beginning of the year); i.e. a positive performance that should be higher than historical averages over 10 years[2] on both sides of the Atlantic, but with an outperformance for US High Yield given the current carry and our default rate assumptions unchanged for 2024 (4%).

Akram Gharbi, Head of High Yield

[1 2]Sources : Groupe La Française, Bloomberg as at 23/08/2024 in local currency. Indices used: Euro High Yield (HE00), U.S. High Yield (H0A0)

ESG

While the world enjoyed an Olympic interlude of wonder, time did not stand still in the markets as "the time for policy adjustment has arrived". The cut in US rates is expected in September 2024 and has already begun to guide the market for the end of the year. This heralds a repositioning of the market towards defensive companies and those negatively correlated to interest rate movements.

It is accompanied by the rise in the polls of K. Harris as the potential future president of the United States. This trend reversal was beneficial to the environmental sphere, while Donald Trump's popularity suggested deregulation of polluting industries and a fresh exit from international agreements.

K. Harris is driving a new proposal as she capitalises on a pragmatic and committed environmental defence liability while positioning herself more pro-business than progressive Democrats. This suggests the possibility of her playing a pivotal role in American leadership on the energy transition by addressing the current bottlenecks in the Green New Deal. In this scenario, the oil industry would be hit the hardest.

Combined, these two factors in the US are positive catalysts for companies that provide climate solutions and for nature, which will benefit from lower rates to redeploy financing for the purpose of ramping up their efforts. Moreover, in a general context of weak growth, this would be beneficial for companies that provide digital technology products and services that improve the competitiveness of industries – from an economic point of view as well as in the management of natural resources or energy.

Finally, companies in the food sector, such as those that increase agricultural yields (suppliers of high-quality seeds resistant to pests and lack of water, precision agriculture, irrigation systems and water treatment, more general sustainable agriculture theme…) are also currently well positioned to benefit from the market environment.

The financing of this sector is all the more important given that the droughts caused by the prolonged El Nino episode are having a longer-term impact in various parts of the world. The situation is expected to be particularly critical over the coming months and would exacerbate an already dramatic hunger crisis. For example, 17% of the population in South Africa needs food aid[1], and Zimbabwe, Zambia and Malawi have declared their hunger crises as a state of emergency. In Europe, agricultural yields are also affected, with, for example, a drop in grape production of more than 40% compared to the average of the last 30 years in southern Spain following the drought[2]. In France, winter rains have massively impacted soft wheat production, which is expected to be down 15-17% compared to 2023[3].

[1] Executive Secretary Elias Magosi at the 44th SADC Summit

[2] https://www.ncei.noaa.gov/access/monitoring/monthly-report/global-drought/202407

[3] Philippe Heusele, Secretary General of the General Association of Wheat Producers in France (AGPB)

The visible signs of increasing pressure on our food supply and therefore indirectly on the preservation and restoration of nature are increasingly central in the field of adaptation to climate change and at the heart of future international discussions at the COP16 – biodiversity – at the end of October in Colombia and COP29 – climate – in mid-November in Azerbaijan.

Marie Lassegnore, CFA, Head of Financial & Extra-Financial Analysis

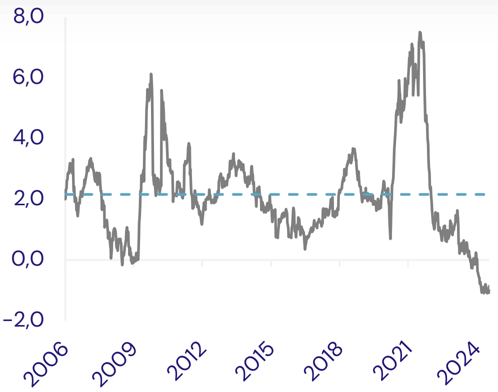
Small and Mid Caps

The macroeconomic context resulting from the Covid crisis and the reopening that followed led to an alignment of circumstances that was unfavourable to the performance of small caps in 2022 and 2023. The latter, driven by inflation and a particularly violent rise in interest rates, prompted investors to move away from risky assets. In the wake of 2023, the first six months of the year confirmed the end of the overstocking situation in many industries, induced by the massive rebuilding of stocks in 2022, heralding a return to a more normalised environment. The cycle seems to have bottomed out for most companies, but the recovery is still awaited, with macroeconomic indicators still struggling, despite a continued strong demand.

The first half of the year once again highlighted the underperformance of small caps, with +7% for the STOXX Small Europe 200 Net Return versus +11% for the STOXX Large Europe 200 Net Return. This underperformance widened in January and then stagnated, suggesting a turnaround in the eyes of investors.

Small caps were particularly affected by high interest rates and by falling activity indicators (PMIs). These companies suffered from both more difficult financing conditions, a greater interest rate effect on their valuation levels and a heightened sensitivity to the economy. The ECB has already begun to ease monetary policy, and falling inflation levels reinforce expectations of a more accommodative monetary policy in the near future. Moreover, the historical correlation between the outperformance of small caps and the PMI index suggests the potential for a rebound in this segment when the cycle starts to rise again.

Valuation gap between Small and Large Caps – in terms of Price Earnings Ratio



Historically, small caps are valued, on average, at a premium of 2.2 P/E points above large caps

As of this day, small caps are undervalued by 1 point compared to large caps

Source: La Française Group, Bloomberg as at 23/08/2024.

In addition, small caps are currently at very low valuation levels, which are relatively unprecedented, both in absolute and relative terms. These exceptionally depressed levels lay the groundwork for optimism in the medium term. Earnings growth, which is structurally higher in this part of the market, continues to be favourable, with earnings per share expected to increase by 11% in 2024 and 2025.

These factors exert an influence on the flow of capital into small caps. Since the end of 2023, large caps have benefited from a return of inflows after two years of outflows, but this momentum is beginning to spread to small caps. Should this trend continue, it would be a strong support for the short- to medium-term performance of this part of the market.

In this context, we choose to maintain our focus and invest in high-quality companies with structural and long-term growth. We are taking advantage of the low points experienced by these growth stocks. Thus, the animal health, diagnostics and construction sectors in the Nordic countries were strengthened in the portfolios. The defence sector is also sought after, following the significantly increased budgets and providing solid visibility in the medium term.

Jean-Pierre Mariaud, Head of European Small & Mid Cap Equities

Large Caps

In the first half of the year, the markets followed the momentum of 2023, with minimal anticipation of rate cuts by central banks. Indices remained on a very dynamic trend, continuing to favour the "*Magnificent 7*[1]" in the United States, although some have begun to correct.

S&P500 performance vs equally weighted S&P500 over a rolling 1 year (base 100)

From the summer onwards, fears of a US recession, after some disappointing macroeconomic figures (employment, ISM Manufacturing), restored credibility to a rate cut in September. This phenomenon led to a widening of the performance gaps within the indices, in favour of the largest caps, reinforcing the concentration effect.

The S&P 500 continued setting new highs, with the most recent at 5669 on 16 July. In addition to the semi-annual publications, which were generally positive, uncertainties have increased, resulting in a return of market volatility:

- Fears about global growth and particularly weak consumption, first in China and potentially in the US in the second half of the year
- The geopolitical context is one from which it is difficult to predict the outcome.
- From a microeconomic point of view, uneven results for the "*Magnificent 7*", with questions about the pace of investment in AI in focus
- Japan raised rates to 0.25%, leading to an unwinding of a magnitude not seen since 1986, with the Nikkei losing nearly 20% in three days

In emerging markets, the index gained 6.5% as of 23 August[2]. Investors are becoming more constructive again now that election uncertainties have been lifted in Brazil, Mexico and India. However, the situation remains complex in China, with the housing market at a standstill and the he government's measures to support households inadequate. However, the prospect of the Fed's pivot and the growth expectations offered by certain markets (India) or thematic (AI, emerging middle class) are positive factors.

In Europe, the political environment severely penalised domestic stocks, particularly French stocks, which have not seen their discount reduced despite positive first-half results. While we maintain a cautious outlook on France, the more favourable interest-rate environment that is emerging could provide a catalyst for a rotation in favour of defensives and quality stocks.

[1]Microsoft, Nvidia, Tesla, Meta, Apple, Alphabet and Amazon

[2]MSCI Emerging Markets in euros,

Source : Groupe La Française, Bloomberg as at 23/08/2024.

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Autumn looks to be complex, but the long-term trends remain: innovation, renewable energy or reindustrialisation. Active equity management makes it possible to identify the winners of tomorrow, in a context of low growth across the board.

Caroline Lamy, Head of Equities

Conclusion

Jean-Louis DELHAY

CIO – Crédit Mutuel Asset Management

The market decline that occurred on 5 August, commonly referred to as "Black Monday", proved to be a relatively short-lived phenomenon. The latter, described as excessive, follows, among other things, an increase in the Bank of Japan's interest rates and a more unfavourable than anticipated US employment report. We took advantage of the market turbulence to increase our equity exposure. At the extraordinary allocation committee meeting on 6 August, the decision was taken to reinforce this strategy and increase our positions on US and European equities in some of our portfolios. Since that time, indices such as the Euro Stoxx 50® (+7%) and the S&P 500 (in euros, nearly +5%) have rebounded, and Japanese equities have returned to a level comparable to those observed before the summer.

Subsequently, the release of data aimed at mitigating the likelihood of a recession in the United States further reinforced the upward trajectory of equity markets and high-yield bonds.

From the perspective of the central bank, the intervention by Fed Chairman Jerome Powell at the central bankers' symposium in Jackson Hole was eagerly awaited. As the Fed's minutes had indicated two days earlier, the institution's president stated that 'the time has come for monetary policy to adjust', suggesting the potential for a first easing of key rates in September. However, the president refrained from specifying the timing and pace of monetary loosening. Consequently, we have entered a gradual cycle of monetary easing in Europe and the United States, which in the medium term should favour risky assets.

Furthermore, we maintain a cautious outlook in light of potential geopolitical uncertainties and the upcoming presidential election in the United States. Mr. Trump's objective is to enhance the "Wetback" operation, which was spearheaded by the Eisenhower administration in 1954. This initiative led to the relocation of 1 million individuals to Mexico. He anticipates that his policies will result in the departure of over 13 million undocumented migrants from the US. Additionally, the implementation of the proposed tariff increases and significant fiscal spending in Trump's program will allow K. Harris to emphasize the potential for increased inflationary pressures, which could impact the current 'soft landing'. Indeed, the moderation of inflation should allow for a sustained easing of monetary policy and sustained economic growth. The upward revision of the second quarter US GDP to 3% is positive news for the candidate, providing a basis to persuade voters that the economy is on the right track. At the same time, it allows the promotion of the idea that a Trump presidency would derail everything.

In light of the recent decline in US and European long-term bond rates, we have adopted a neutral stance on duration. Our preference for assets in euros over dollars remains unchanged.

In conclusion, we are monitoring future decisions by central banks and potential rate cuts in Europe and the United States, given the current indications of a downturn. Our outlook on equity markets remains positive. We are also maintaining a neutral modified duration position on the bond markets. Finally, we are maintaining a positive view on gold, which offers diversification and is uncorrelated with risky assets, and should benefit from the continued fall in US real rates.

Source : Groupe La Française as of 23/08/2024.

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Internet contact details of the supervisory authorities : Autorité de Contrôle Prudentiel et de Résolution (ACPR) www.acpr.banque-france.fr, Autorité des Marchés Financiers (AMF) www.amf-france.org

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