Market View

November 2023

Executive Summary

- Geopolitical escalation and the continued yield curve bear steepening have pushed the S&P 500 below important medium-term support levels with weak risk sentiment remaining the only clear tactical buying signal.
- Better than expected S&P 500 earnings are countered by downward revisions to full-year 2023 and 2024 forecasts.
- The European macro backdrop has been weakening for some time, and Q3 was no exception. Similarly, European markets are underperforming the US (e.g. SPI has turned negative YTD).
- US data remained robust through September but with increasingly stagflationary overtones. We expect this resiliency to begin dissipating in November/December.
- US Leading indicators continue to fall and are now on track for an 18th month of decline – the longest sequence since the 2008/09 Global Financial Crisis.

S&P 500 Sees Third Straight Month of Decline

- As of writing, the S&P 500 is on track for its third consecutive monthly decline, which has not happened since the 2020 Covid Crash.
- The nominal US 10-year yield hitting 5% and 10-year real rates jumping to 2.50% despite a spike in geopolitical risk, underscores the extent of financial conditions tightening that has been going on over the past few weeks.
- Credit spreads have widened too but remain well below their post-SVB wides earlier this year.

Market Development

World

- It's hard to see what would drive a significant and sustained rally in bonds without a US recession - a beginning of which we still expect in Q1 2024 (we look for a spike in US jobless claims over the next 6 months as confirmation).
- We are happy to see Gold (our primary portfolio diversifier) working, and we maintain a bullish medium-term view. Gold tends to rally ahead and into US recessions historically.
- US Q3 GDP (preliminary) increased by an impressive 4.9% annualised, surpassing the Bloomberg consensus of 4.5%, but must be put in context of the running USD ~2 trillion deficit.

Europe

- Inflation in Germany, Spain and Italy surprised on the low side with preliminary October prints. The disinflation tailwind from energy base-effects will start to wane from next month on. This will make it difficult to reach 2% CPI before Q1 2024 unless energy prices drop in November and December, which is unlikely given the bullish supply/demand dynamics seen in natural gas space according to Steno Research.

Switzerland

- The SNB surprised by announcing that it would no longer pay interest on the minimum reserves that banks are required to hold with it. In addition, a multiplier will be lowered, which determines how much of the money parked with the central bank will receive the full interest rate. Together, the two changes will save the SNB an estimated 600 million Swiss francs a year. In this context, note that the SNB is still carrying a huge balance sheet loss from last year and will therefore probably not pay any dividends to the state and cantons in Switzerland this year either.

First Signs of Cycle-End emerging in the US?

- The Fed is in a tough spot, measures of inflation have reaccelerated in recent months and Q3 GDP was strong, however largely driven by government spending. Note in this context, that historically GDP growth is often surprisingly strong right before a recession (BofA's table in the chart section below).
- The implication is that the Fed needs to remain hawkish and likely will keep rates high until the labour market shows significant weakness.
- Worsening the Fed's situation is the US fiscal recklessness, which has become the key concern of capital markets this autumn - with the 12-month budget deficit still running above 6% of nominal GDP.
- The federal deficit approximately doubled in the fiscal year through September compared with the year before, effectively reaching $2.02 trillion, forcing the Treasury to step up its borrowing.
- With the Fed not buying bonds (QT), the private market is demanding to be paid for the massive supply of bonds resulting in a vicious bear steepening.

- Powell himself called the US fiscal path "ultimately unsustainable" at the Economic Club of New York in October.
- The Treasury Department released the quarterly refinancing report for Q4 on 30 October.
  - Yellen cut her net borrowing estimate for Q4 to $776 billion, against the $852 billion for the period predicted in late July – yields declined in a first response.
  - Despite the reduction in the estimate, the new projection still marks a record borrowing amount for the calendar fourth quarter.

How much longer can the US cycle be extended by heavy deficit spending? At least some equity market internals are beginning to flag end-of-cycle risks.

- Cyclicals vs Defensives ex commodities have started rolling over
- Small Caps (which tend to feel tighter credit conditions first) are significantly underperforming large caps
- The US reporting season has led to the fastest pace of EPS downgrades in almost a year

Notably, this earnings season has witnessed the weakest sales beats in the US in the past ten years (with Europe faring even worse). Maintaining earnings at current levels via margins might become challenging without labour force reductions (the end of "labour hoarding"?).

- RBC Capital on the Q3 earnings season calls: *"Some companies have emphasised resiliency, stabilisation and normalisation, but we are reading a lot more about uncertainty, challenging macro conditions, softening and caution"*

Positioning

We had anticipated the transition to a sticky inflation narrative since July ("peak goldilocks"). The tilt towards energy worked so far in this context. Similarly, we anticipate peak "higher-for-longer" over the next 1-3 months and a shift to US growth concerns. Our medium-term outlook remains unchanged. We expect the beginning of a hard landing towards Q1 2024 in the US.(The window for a beginning hard landing is 23 November-24 April based on a 42Macro yield curve backtest).

- Consequently, we perceive attractive medium-term risk/reward in 2-year US Treasuries for a hard landing trade without much downside. We think of it as a call option on a forced Fed pivot with aggressive rate cuts in H2 2024. Markets currently price merely 2-3 rate cuts by year-end 2024 – far too few if a hard landing materialises. If the Fed doesn't cut, we would just hold another year and still earn 5% p.a. in USD.
- On a longer timeframe, real yields of ~2.4% for US 5-year and 10year inflation protected Government bonds (TIPS) also appear increasingly attractive (10-year real yields reached 3% in autumn of 08' – the best buying opportunity for the next 20 years). TIPS are the "true buy-and-hold, risk free asset" – but it is essential to correctly match your investment time horizon.

On a tactical outlook, the weak sentiment and oversold conditions speak for an equity bounce provided that yields work-off their overbought conditions and calm down a bit. However, any chances for a meaningful Q4 rally have declined with the clear break of the 200-dma in the S&P 500 late October.

Chart

"Mini" recovery cycles (US Q1-Q3 2023) within a broader slowdown are historically not uncommon towards cycle end.

US nominal & real YoY GDP growth at the start of recession

	GDP growth YoY % (in quarter that recession began)	
Start of Recession	Nominal	Real
November 1948	7.9%	3.9%
July 1953	6.4%	5.4%
August 1957	6.3%	3.1%
April 1960	3.5%	2.1%
December 1969	7.2%	2.0%
November 1973	11.1%	4.0%
January 1980	10.4%	1.4%
July 1981	14.1%	4.3%
July 1990	5.6%	1.7%
March 2001	4.7%	2.2%
December 2007	4.8%	2.2%
February 2020	2.5%	0.6%

Source: BofA Global Investment Strategy, Bloomberg

Sources: Bloomberg, Morgan Stanley, Bank of America, Goldman Sachs, The Macro Compass, The Market Ear, Steno Research, 42Macro, JPM, Hightower Naples, ZKB, Strategas, RBC Capital

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