N° 178

1st quarter 2024

Perspectives

Financial markets analysis

- The resilience of the US economy in 2023 does not mean there will be no recession in 2024.
- In countries other than the United States, economic conditions are weak, with the eurozone close to recession and China on the brink of deflation.
- Now that inflation is slowing, the US Federal Reserve has already signalled its intention to cut interest rates in 2024, despite the absence of any marked deterioration in the labour market.

- The degree of concentration in the major stock market indices argues in favour of active management.
- The upward trend in the Japanese market seems well established.
- Gold should benefit from central banks' return to more expansive monetary policies.

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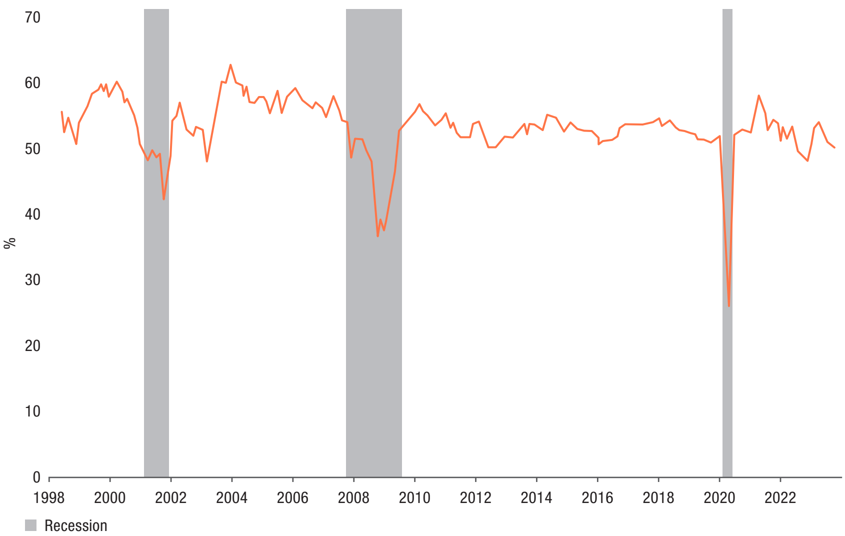
Macroeconomic environment

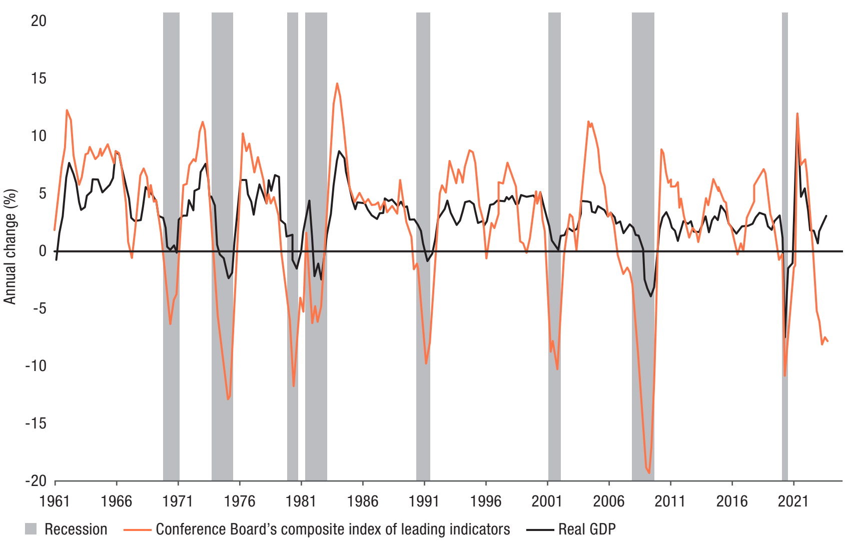
GLOBAL COMPOSITE PMI ACTIVITY INDEX



Source: Evercore ISI

Economic activity is continuing to slow worldwide. The main exception is the United States, where GDP growth is still relatively robust. Analysts' consensus estimates suggest that US GDP increased by 2.4% in 2023, which would represent an acceleration from the 1.9% recorded in 2022. In contrast, eurozone GDP growth is projected to have fallen to 0.5% in 2023 compared to 3.4% the previous year. In China, the estimated GDP growth rate of 5.2% in 2023, up from 3.0% in 2022, does not reflect the real economic situation due to the shutdown of the economy during the pandemic and, consequently, a very favourable base effect for last year. A genuine recovery in activity after the economy reopened in early 2023 is still some way off, as persistent difficulties in the key construction sector continue to weigh heavily on the country's general business climate. Overall, the global economy is still in fragile territory, especially as the central banks' monetary tightening will only produce its full effect in the first half of 2024.

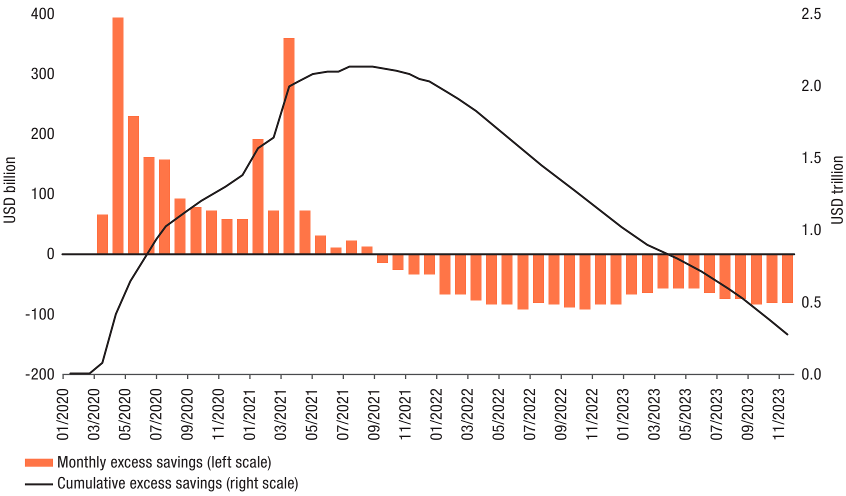
US LEADING INDICATORS AND GDP GROWTH



Source: Conference Board, William Blair Equity Research

Whereas, a year ago, the consensus view among analysts was a recession scenario, most are now predicting a soft landing for the US economy. This turnaround is due to favourable trends in economic activity throughout 2023, so far defying the most reliable leading indicators that have correctly predicted every recession in the post-war period. Nevertheless, the absence of a contraction in activity – despite the inversion of the yield curve, the decline in the Conference Board's composite index of leading indicators, and tighter credit conditions imposed by commercial banks – does not rule out the possibility of a recession in 2024. Historically, the average time between the start of the Federal Reserve's interest rate hikes and the onset of recession is 22 months. As the start date for raising interest rates was March 2022, the first half of 2024 would, based on previous cycles, be the period in which the rate hike will produce its maximum effect. And, as the illustrious writer Mark Twain once said, although history doesn't repeat itself, it often rhymes. In other words, a slight delay in the onset of recession seems far more likely than no contraction at all after one of the biggest monetary tightening cycles in the Federal Reserve's history.

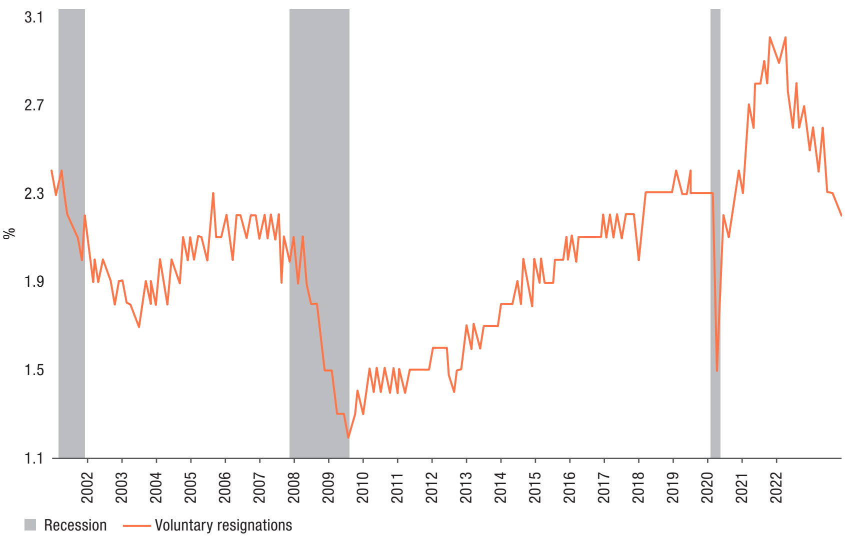
EXCESS SAVINGS IN THE US SINCE THE START OF THE PANDEMIC IN 2020



Source: Bureau of Economic Analysis, Federal Reserve Bank of San Francisco, Jefferies

The remarkable resilience of the US economy is mainly due to the high level of household consumption and public spending. Resilient household consumption is not a new phenomenon. Even during most previous post-war recessions, household consumption did not generally decline, thanks to the low cyclicality of services activities and trade in non-durable goods. The great financial crisis of 2008 was more the exception than the rule, with the slump in property values having a considerable impact on household purchasing power. In the current cycle, domestic consumption is additionally benefiting from the excess financial reserves built up during the pandemic, to a large extent offsetting the loss of purchasing power resulting from rising inflation. Meanwhile, the high level of the budget deficit is an added source of support unprecedented at a time of such low unemployment. However, these two support factors could gradually diminish in the coming months. Household purchasing power will be affected by the gradual depletion of excess reserves, while the deployment of new fiscal measures could be complicated by the Democrats and Republicans both being less willing to compromise in the run-up to the November elections.

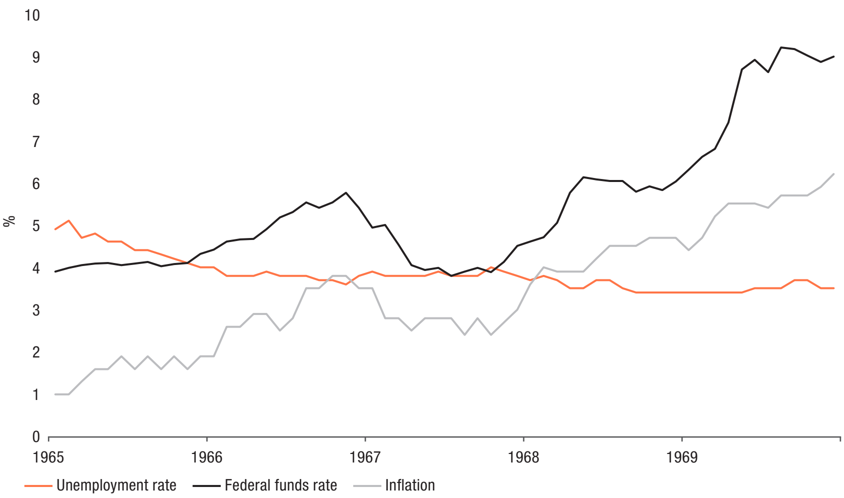
US QUITS RATE



Source: Bureau of Labor Statistics, Evercore ISI

A significant deterioration in the labour market, which is usually synonymous with the onset of recession, is not yet in evidence. Nevertheless, signs of weakness that often herald a more pronounced deterioration are starting to multiply. The reduction in job vacancies, voluntary resignations and temporary positions suggests that the imbalance between supply and demand that has characterised the labour market since the end of the post-pandemic recovery has been rectified. Over the past six months, net job creation has mainly been confined to the public sector and health and social care, while hiring momentum in the rest of the private sector has slowed considerably. To date, companies have not made large-scale redundancies. Like households, they have been drawing on the ample financial reserves built up during the pandemic boom. However, the slowdown in sales growth along with ongoing notable wage increases should soon trigger the traditional reflex among companies that involves cutting staff costs and capital expenditure in order to protect profit margins and cash flows.

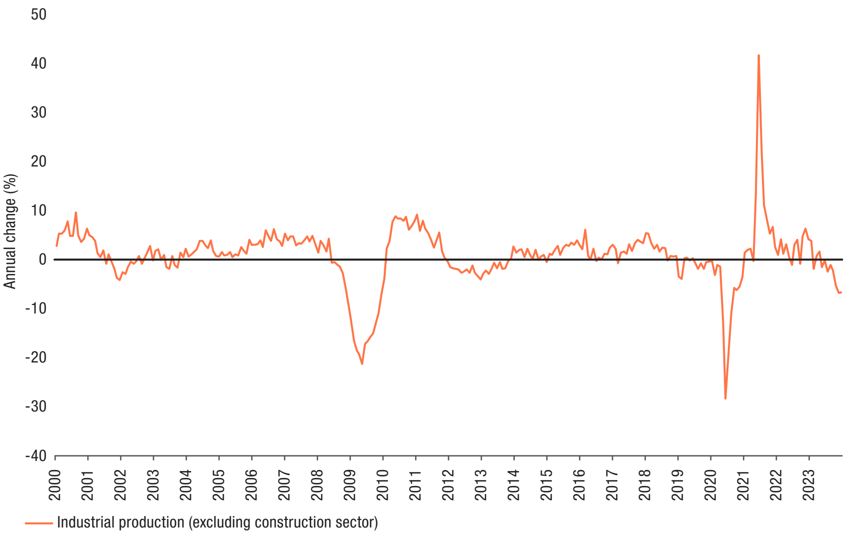
US INTEREST RATES, UNEMPLOYMENT AND INFLATION FROM 1965 TO 1970



Source: Bureau of Labor Statistics, Federal Reserve Bank of New York, Bloomberg

The main hope of avoiding economic contraction lies in the premature easing of the Federal Reserve's monetary policy, which would see it reducing its key interest rates before any significant deterioration of the labour market. In this respect, the current situation could become comparable to that of 1967, when the Fed began cutting its key rates after the yield curve's inversion but before the unemployment rate had begun to rise. The positive effect of this strategy was that activity picked up before redundancies began. This avoided recession despite the inversion of the yield curve and was a real exception in the post-war period. The downside was the rapid return of rising prices, laying the foundations for excessive inflation throughout the decade that followed. Today, the monetary authorities seem to be facing a similar dilemma. A premature cut in interest rates might manage to prevent the onset of recession, but such a strategy would probably lead to a rapid return of inflation requiring an even more drastic rise in interest rates in the next monetary tightening cycle.

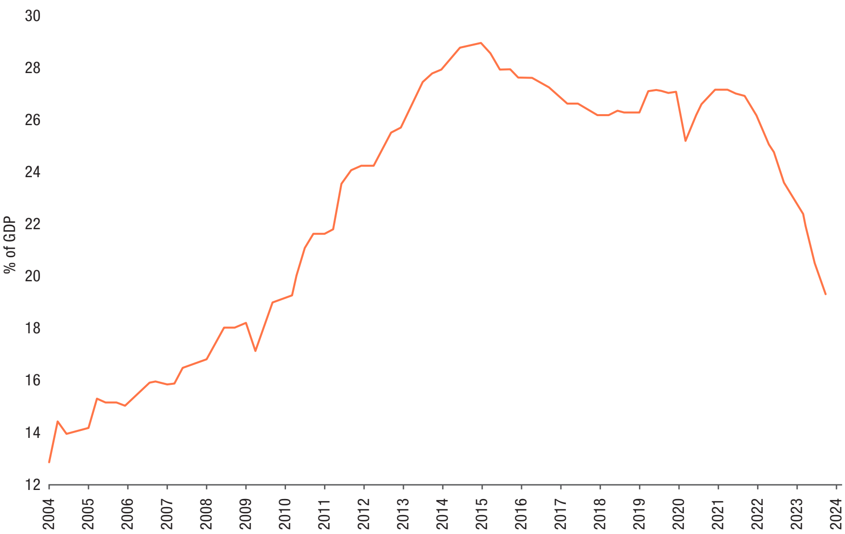
EUROZONE INDUSTRIAL PRODUCTION



Source: Eurostat, Bloomberg

Economic activity is much weaker in Europe than in the United States. Higher energy costs and less fiscal support during the pandemic explain the difference in growth rates between the two regions. Industrial production has been falling for several months, and the post-pandemic recovery in services is also beginning to fade. If eurozone GDP were to fall again in the fourth quarter after the 0.1% decline in the third, the eurozone would meet the technical criterion of two consecutive quarters of falling activity that is generally used to define recession. It is currently hard to imagine what factors might trigger a new economic dynamic in Europe. In Germany, the brake on public debt enshrined in the constitution limits the government's room for manoeuvre and it has not yet drafted a budget for 2024. In France, the loss of vigour in business investment and household consumption means that growth forecasts are constantly being revised downwards. Hopes rest on a rapid continuation of the disinflation process, which would restore household purchasing power and could thus prompt a re-acceleration in growth from 2025 at the latest.

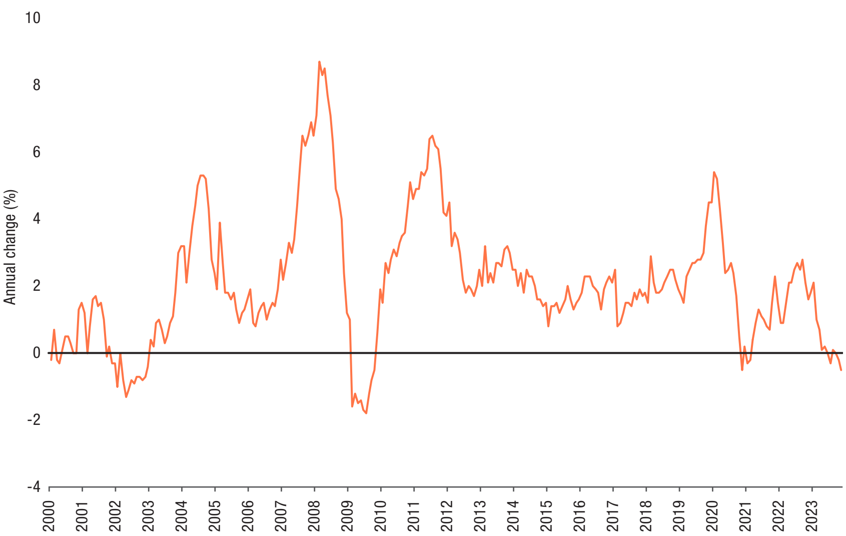
PROPERTY INVESTMENT IN CHINA



Source: Piper Sandler

Although China appears to be slightly ahead of its target of 5% GDP growth in 2023, the country's economic situation remains problematic. Since the economy reopened at the start of last year, the Chinese authorities have failed to generate any real economic momentum. The main concern is the state of the property sector, which had become too large a part of the economy. This is why the government has taken a number of measures in recent years to curb growth within the sector, the most important of these being to reduce the debt capacity of property developers. The slogan 'houses are for living in, not for speculation', first proclaimed by President Xi Jinping in 2016, became the symbol of the fight against excessive construction. Now, eight years on, property activity is struggling to get back on a solid footing. Several major developers are on the verge of bankruptcy, local governments are having difficulty selling land which is weighing on their revenues, and the public are wary because of uncertainties about the potential appreciation of an investment in bricks and mortar. If the Beijing government does not adopt more substantial measures, it could take years rather than months for the property sector to recover.

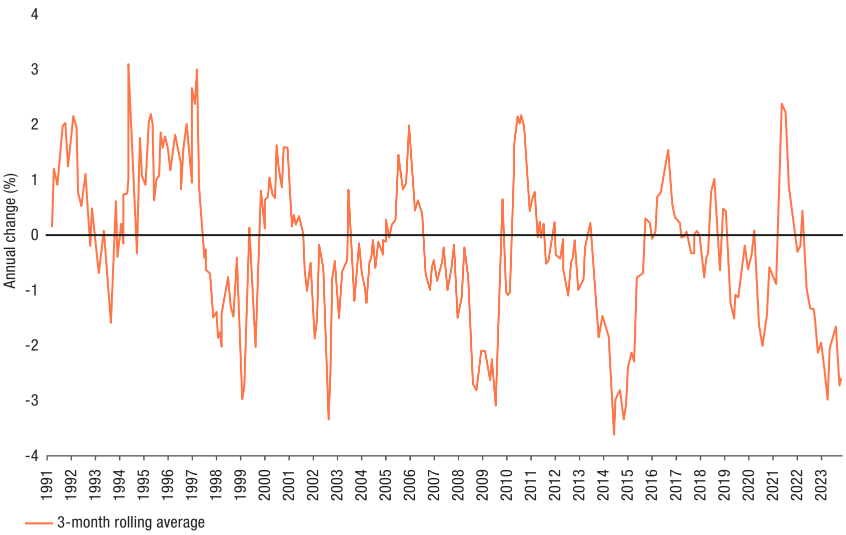
INFLATION IN CHINA



Source: National Bureau of Statistics of China, Bloomberg

In the short term, China may be tempted to aim for faster growth through increased exports. Although domestic demand does not appear to be about to collapse, the normalised pace of growth in retail sales remains well below that of industrial manufacturing, leading to excess production compared to domestic consumption needs. This imbalance between supply and demand is exacerbating pressure on prices, with figures for the last three months showing inflation in negative territory. On the other hand, the United States and Europe are not going to allow (often unfair) Chinese competition to threaten the survival of local producers, especially at a time when Western countries are seeking to safeguard their production chains and become less dependent on the world's leading manufacturing centre. In the medium and long term, China will have to redefine its economic growth model. Structural problems in the property sector, a falling birth rate leading to a zero or even negative demographic contribution, and geopolitical tensions reducing the potential for exports are set to lead to permanently weaker growth in the Chinese economy in the years ahead.

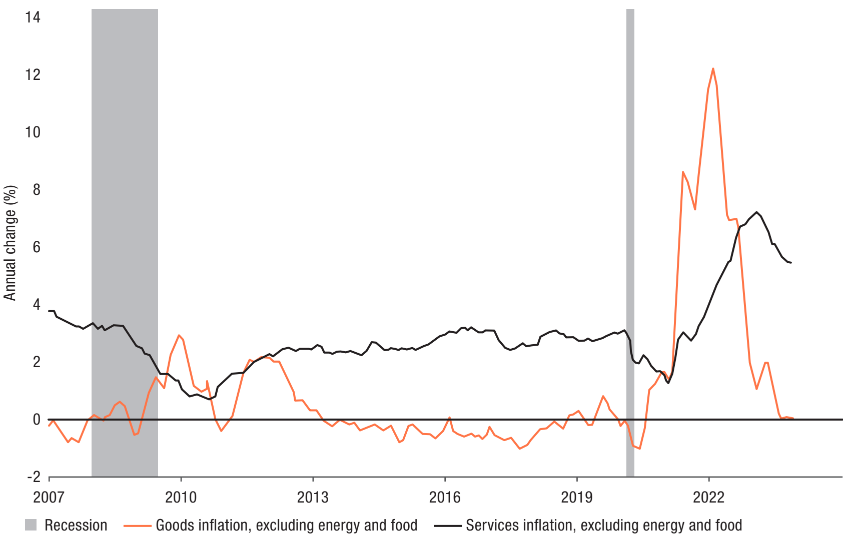
REAL AVERAGE MONTHLY WAGE IN JAPAN



Source: Ministry of Health, Labour and Welfare, Jefferies

In Japan, GDP growth for full-year 2023 is estimated at 2%, up from 1% a year earlier. Economic activity has mainly benefited from the favourable trend in business investment and the strength of exports helped by the depreciation of the yen. However, the downside of the weak yen is its positive contribution to inflation, impacting household purchasing power, which fell in real terms in spite of the most favourable wage negotiations in Japan for over thirty years. Despite core inflation (excluding fresh food) exceeding 2% for 20 months in a row, the Bank of Japan has not yet abandoned its negative interest rate policy. Recent comments by the Governor of the BoJ suggest a slow path towards normalisation of its monetary policy, but the exit plan and timetable for any such action have yet to be specified. With the deteriorating outlook for export growth and business investment as a result of the slowdown in global demand, an improvement in household consumption would seem vital to avoid a significant weakening in activity over the coming year.

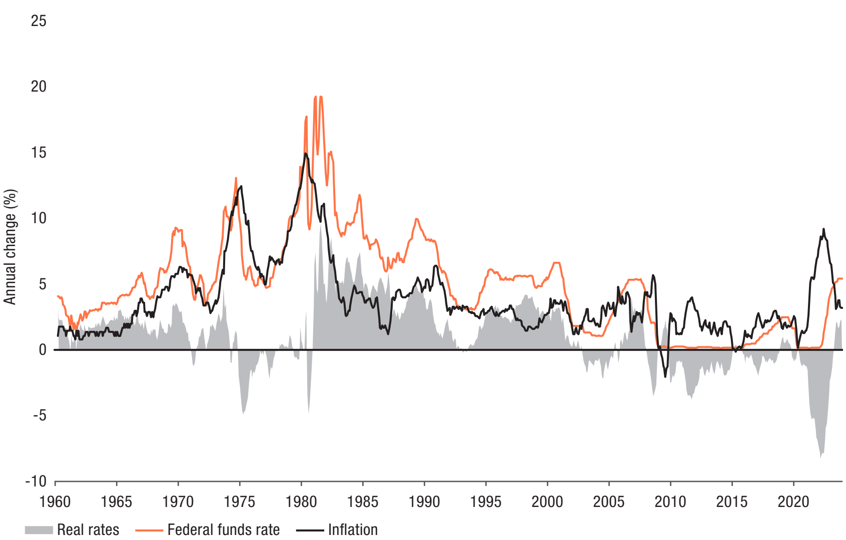
US INFLATION



Source: Bureau of Labor Statistics, Evercore ISI

While the general slowdown in inflation was fairly predictable a year ago, the situation now seems a little less clear. In the goods sector, the restoration of supply chains after the end of the pandemic, together with the gradual easing of commodity prices after the energy crisis in 2022, should inevitably lead to a reduction in price rises in 2023, especially as the comparison bases had become particularly high. However, this process of disinflation seems to have come to an end, with goods inflation having fallen to almost 0%. In the services sector, inflationary pressures are proving more tenacious given the close correlation between services inflation and wage trends, with the latter continuing to benefit from the favourable agreements reached over the past year. This is why a continuation of the disinflation process depends primarily on developments in the labour market. If our hypothesis of a recession in the United States were to materialise in the months ahead, the rise in the unemployment rate would lead to weakening demand for many services, and hence to less pressure on their prices. On the other hand, if the economic slowdown ends in a soft landing for activity, inflation could prove more stubborn and remain stuck above the central banks' 2% target.

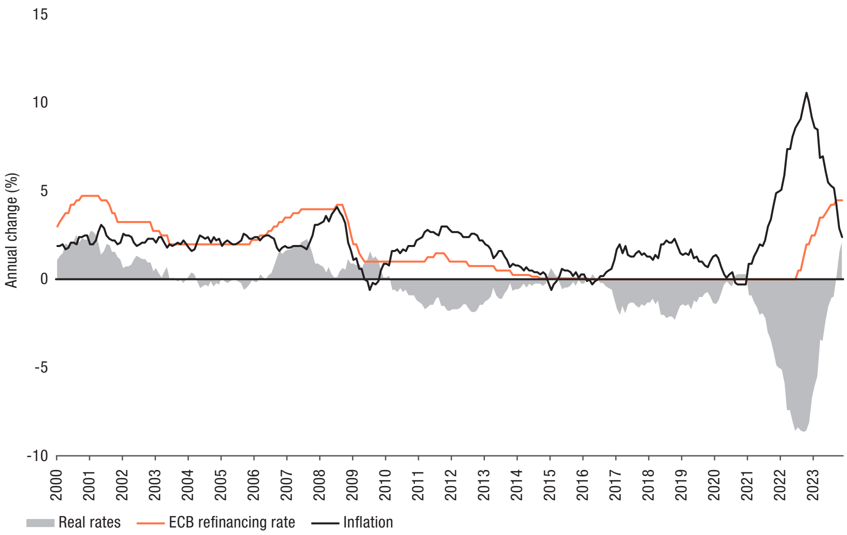
US MONETARY POLICY



Source: Federal Reserve Bank of New York, Bureau of Labor Statistics, Bloomberg

Since the 25 basis point hike in July, the US Federal Reserve has not made any changes to its key rates and the target range for the federal funds rate remains 5.25%-5.50%. At the last meeting of the monetary policy committee in December, Chairman Jerome Powell significantly shifted his position, suggesting for the first time since the start of the monetary tightening campaign that the next move for key rates could be downwards. This change in guidance was all the more surprising given that, over the previous few weeks, Powell had consistently repeated that higher interest rates for longer were essential to bring inflation back towards the 2% target. He effectively endorsed the expectations of analysts who, following the slowdown in inflation, are now expecting six interest rate cuts in 2024, albeit double the Fed's official forecasts. The main risk of major monetary easing before any significant deterioration in the labour market is a rapid re-acceleration of inflation, as was the case in 1967, which necessitated even more drastic monetary tightening at a later stage.

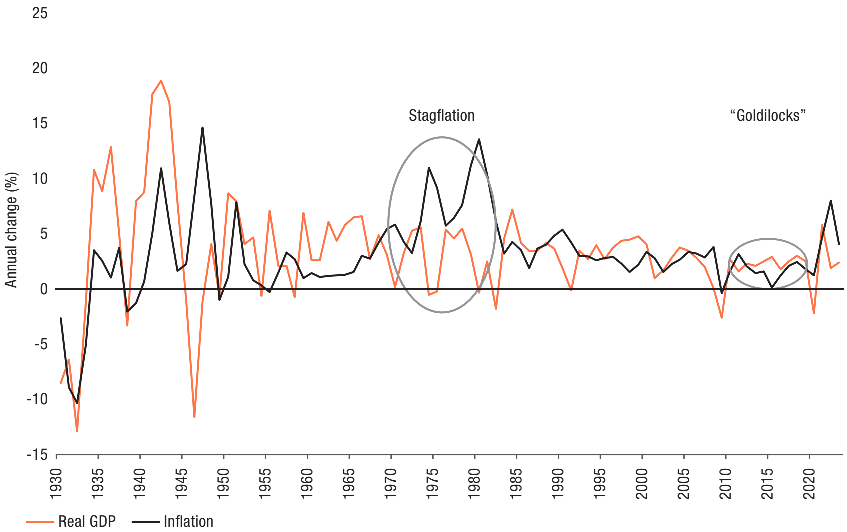
EUROZONE MONETARY POLICY



Source: European Central Bank, Eurostat, Bloomberg

In the eurozone, the European Central Bank last raised key interest rates in September. Since then, the European monetary authorities have left their deposit rate unchanged at 4.0% and their refinancing rate at 4.5%. Unlike her American counterpart, Christine Lagarde is more reluctant to signal a U-turn in the direction of key interest rates, despite weaker economic growth than in the United States. One reason for this could be the difference in their mandates: the ECB is only responsible for price stability, whereas the Federal Reserve is also required to consider the level of employment. Another reason could be the time lag between economic cycles, with the ECB often tending to follow the Federal Reserve's decisions after a slight delay. Despite Christine Lagarde's unchanged guidance, the consensus among analysts is, as in the US, for a cut in key interest rates of around 1.5% by December 2024. Although these forecasts diverge considerably from the official guidance, the likelihood of this happening depends mainly on economic developments during the year. If the European economy were to weaken further, a cut of this magnitude in key rates would become a realistic option.

REAL GDP AND INFLATION IN THE US SINCE 1930

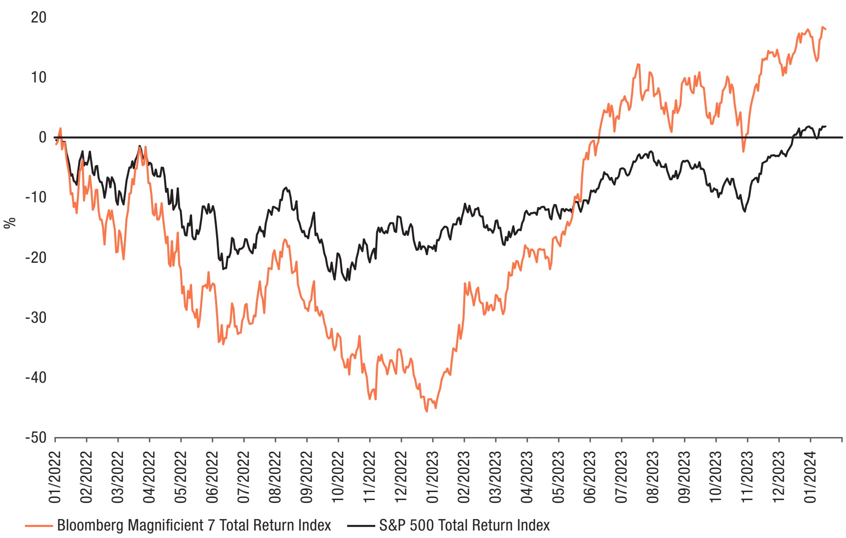


Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Bloomberg

As things stand, 2024 looks like being a pivotal year, which could determine the direction of the global economy in the years ahead. Will the economic slowdown in the United States end in a soft landing for activity and a return of inflation to around 2% without a phase of contraction, evolving towards an environment comparable to the 2012-2019 period that preceded the pandemic? Characterised by moderate economic growth and low inflation, this is often referred to as a 'Goldilocks scenario' because the configuration is 'just right' for the financial markets. Or, conversely, will this economic slowdown lead to recession, as has always (with one exception) been the case after an inversion of the US yield curve, followed by a more volatile economic environment, characterised by alternating years of higher and lower growth and inflation? While, not unlike the period of stagflation in the 1970s, it would be additionally dominated by geopolitical tensions, the abandonment of fiscal discipline, and shortages of labour and natural resources. Although we think the second scenario is more probable – as always, only time will tell.

Financial markets

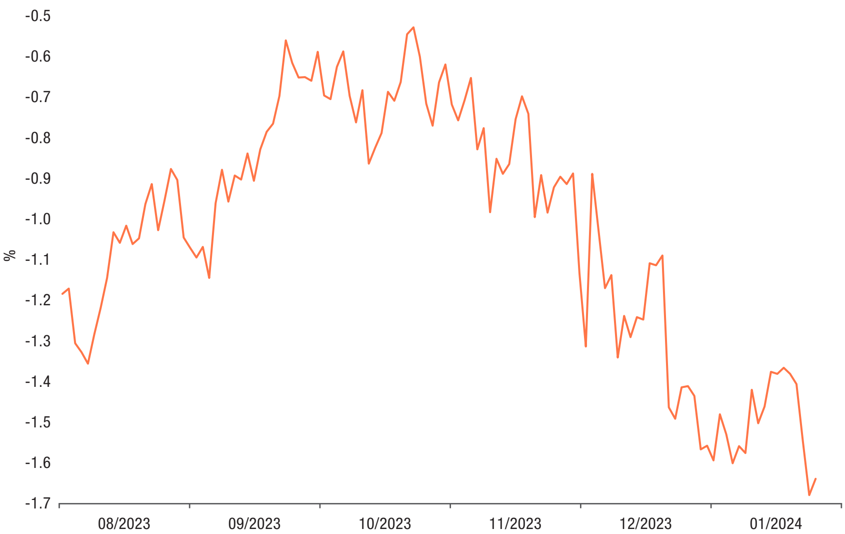
S&P 500 AND MAGNIFICENT 7 OVER 2 YEARS



Source: Macrobond/Bloomberg

On the stock markets, 2023 was a year for optimists. The price rebound that began in the fourth quarter of 2022 continued, enabling the main indices to recoup the losses of 2022 and even reach new highs in some cases. Two factors appear to have been behind this renewed optimism. Firstly, fears that the US economy might slip into recession gradually dissipated, replaced by expectations of a soft landing. Secondly, the emergence of the artificial intelligence theme captured the imagination of investors and gave a new lease of life to major technology stocks. It is these stocks that have driven the indices upwards, starting with the S&P 500 in the USA, whose progress is essentially based on the performance of what we now tend to call the 'Magnificent 7' (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla).

FED FUNDS FUTURES IMPLIED RATE CUTS BY THE END OF 2024 (IN %)



Source: Jefferies

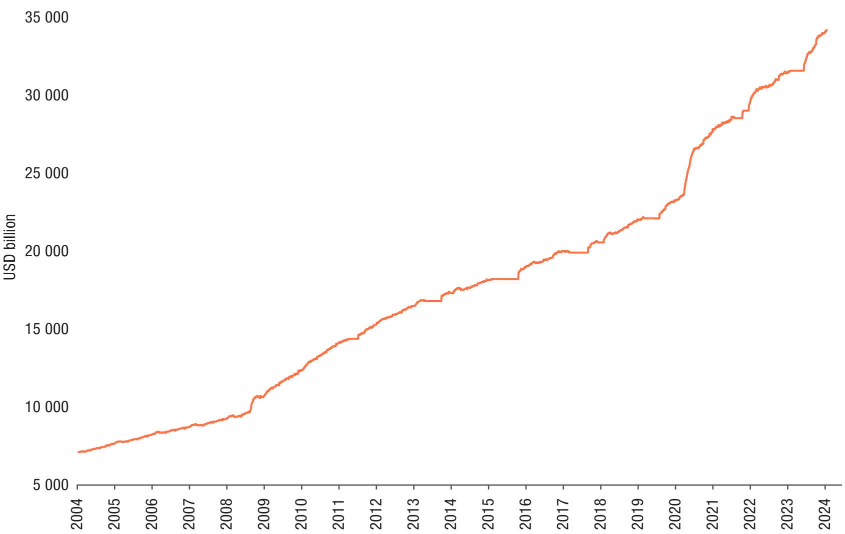
At the start of 2023, a significant number of investors were worried about a possible recession in the USA and further monetary tightening by central banks. At the start of 2024, these fears have given way to very optimistic expectations. The US economy is expected to make a soft landing, allowing corporate profits to grow. At the same time, investors are banking on a significant loosening of monetary policy by the Federal Reserve, which would see the US central bank cut its key rate by some 150 basis points. The fact that these two scenarios are somewhat contradictory does not seem to worry the markets. Indeed, if the US economy proves resilient, there is no reason for the monetary authorities to loosen monetary policy so significantly. If, on the other hand, they feel obliged to do so, it's because the deterioration in economic activity is proving to be greater than expected, which would not be good for corporate profits. Not to mention the fact that in an election year, the Federal Reserve normally refrains from making major policy changes to avoid being accused of influencing the election.

MAGNIFICENT 7 PRICE/EARNINGS RATIO OVER 1 YEAR

Source: Macrobond/Bloomberg

2023 was another very difficult year for active management, particularly in the USA. Unless we believe that stock market indices will continue to be driven upwards by a limited number of stocks, however, things should gradually change. The degree of concentration in the S&P 500 is historically high. In the past, this degree of concentration has not boded well for the index's performance. What's more, the sharp rise in the prices of the Magnificent 7s, which today constitute virtually an asset class in their own right, in 2023 is largely explained by a further expansion in their valuation multiples, rather than by their earnings growth. This multiple expansion may come as a surprise, given the continuing monetary tightening by central banks in the first half of the year and the rise in long-term interest rates (until October). Apple, Amazon, Alphabet or Microsoft are certainly excellent companies, but they would also be excellent companies at half the price.

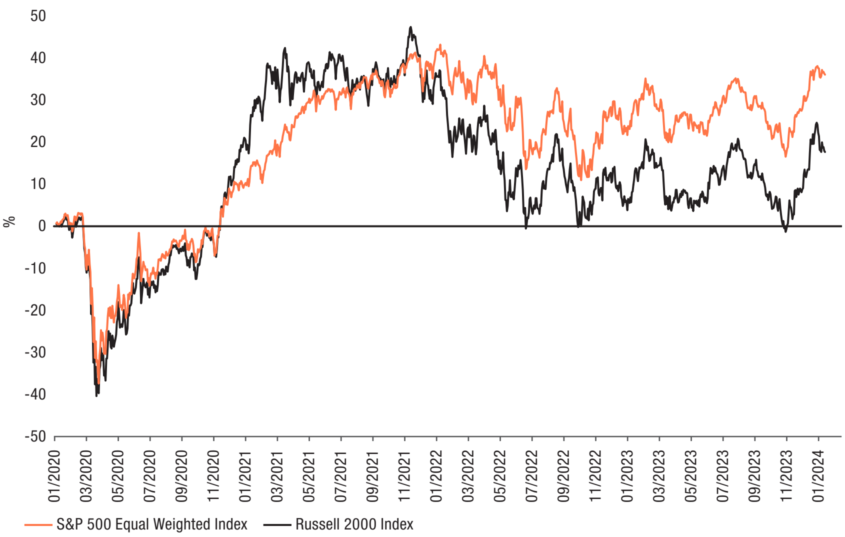
TOTAL OUTSTANDING GOVERNMENT DEBT IN THE USA



Source: Macrobond/Bloomberg

One factor that may have argued in favour of large US technology stocks, and may continue to do so, is that they have the potential to replace US government bonds in the portfolios of large foreign investors. Insofar as the US has a large trade deficit, it must have a capital surplus. The dollars held by foreigners as a result of their trade with the United States have long been invested in US government bonds. However, the fragmentation of the global economy, the ever-increasing US public debt with the ever-growing budget deficit, and the fear of the US monetizing its debt and using the dollar as a political weapon have shaken the confidence of foreign investors in what has long been the safe haven par excellence. As a result, they may be turning their attention to the shares of the big technology companies. All the more so as these companies are regularly buying back their own shares, thus reducing their supply, while the supply of government bonds is only increasing under the impact of ongoing budget deficits.

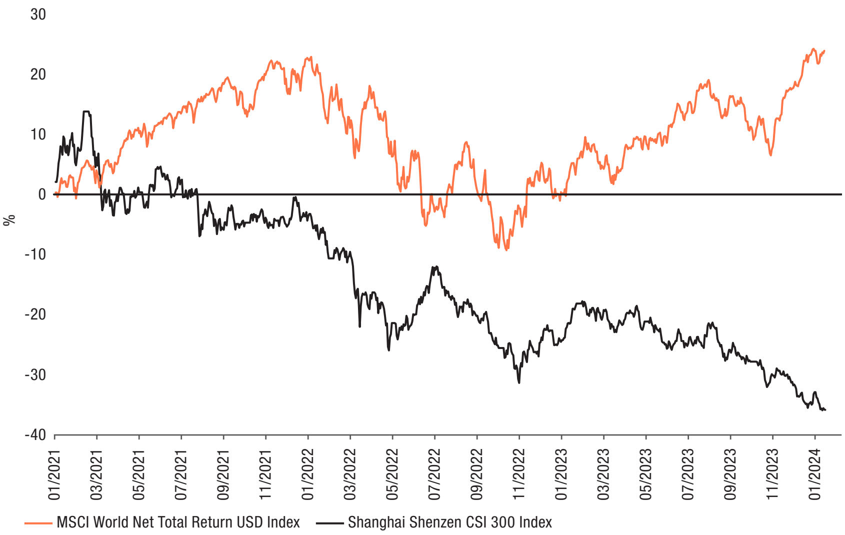
S&P 500 AND RUSSELL 2000 INDICES OVER 5 YEARS



Source: Macrobond/Bloomberg

Apart from the big technology stocks that clearly stood out in 2023, to which we could add the pharmaceutical companies Eli Lilly and Novo Nordisk with their blockbuster anti-obesity drugs, many stocks turned in a much more pedestrian performance. These stocks were affected by rising interest rates, economic or geopolitical uncertainties, or simply failed to capture the imagination of investors. Small-cap companies performed significantly worse than their larger counterparts. In the USA, the Russell 2000 index remains some 20% below its level at the end of 2021, while the S&P 500 index has returned to its high. The Swiss market also illustrates the fact that many stocks did not participate in last year's rally. The SMI index includes a large number of top-quality companies, but underperformed significantly last year. It was penalized by its rather defensive nature at a time when fears of recession gradually disappeared, and by its lack of technology stocks.

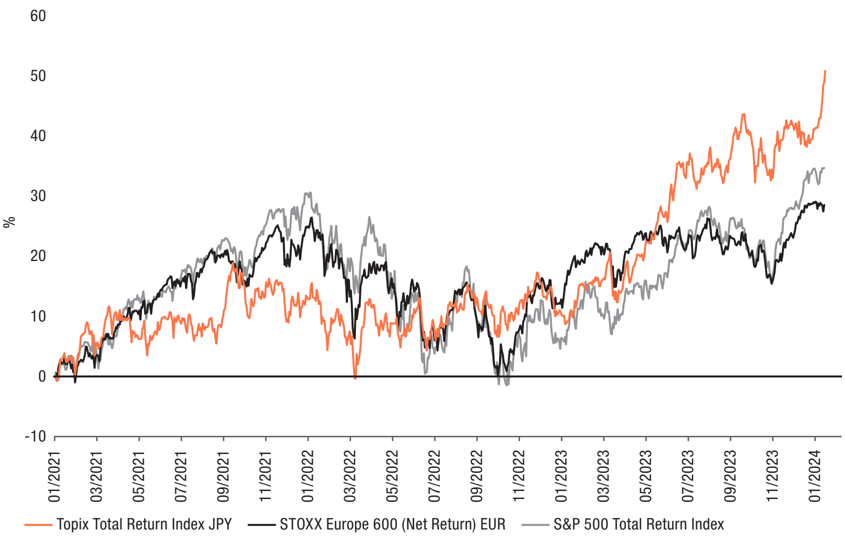
CHINESE AND WORLD EQUITY INDICES OVER 3 YEARS



Source: Macrobond/Bloomberg

The Chinese market continued its downward spiral last year. Over the past two years, it has underperformed the world index by some 60%. The reasons for this underperformance range from geopolitical tensions and economic disappointments to fears that the Communist Party could change the rules of the game at any moment. As the Chinese market currently still occupies an important place in Asian indices, a number of index providers are beginning to offer indices that exclude China. Today, there are essentially two ways of approaching the Chinese market. The first is to say that, since the rules of the game in China are different, and the interests of the Party clearly prevail over those of shareholders, one shouldn't invest there. The second is that, to invest in this market, Chinese equities must offer a particularly high risk premium. In other words, their valuation multiples must be low. This is the case today. The Chinese market has been neglected by both domestic and foreign investors, and offers a risk premium well above its historical average.

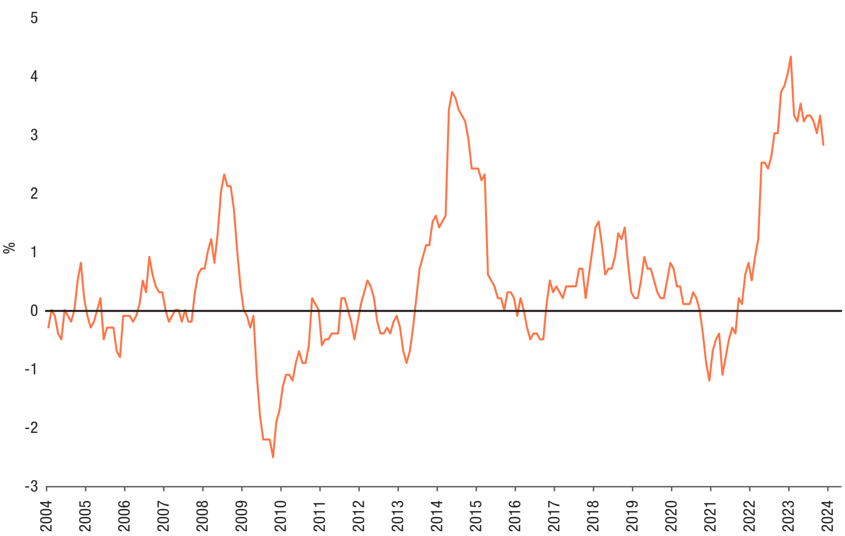
S&P 500, STOXX 600 AND TOPIX INDICES OVER 3 YEARS



Source: Macrobond/Bloomberg

In 2023, the Nikkei 225 index finally returned to the 30,000 level it first reached in 1989. In local currency terms, the Japanese market has significantly outperformed the US and European markets over the past three years. Intermediate corrections are always possible, but the upward trend of the Japanese market is well established. This trend is underpinned by improvements in corporate governance. While Japanese companies have always shown operational efficiency, their capital management left much to be desired. Their main objective was to gain market share, which often led to poor capital allocation and low return on capital employed. What's more, shareholders' interests were rarely taken into account. All this began to change a decade ago with the Abenomics program of former Prime Minister Shinzo Abe. Today, things are gathering pace with the emergence of a number of activist investors and pressure from local institutional investors.

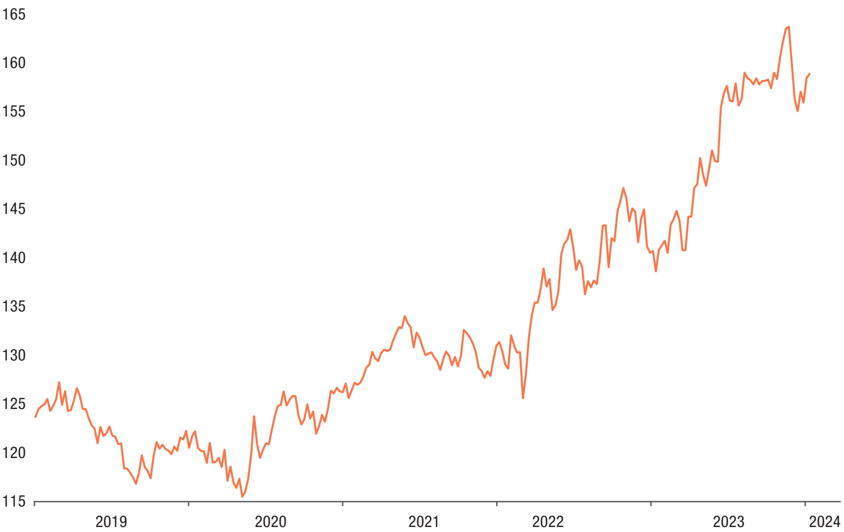
INFLATION RATE IN JAPAN



Source: Macrobond/Bloomberg

While improved corporate governance is the main argument in favour of the Japanese market, other factors should also help. The end of the deflationary era is having a positive effect on corporate earnings. It is certainly easier for companies to increase their sales in an environment where nominal growth is 3% to 4% (1% to 2% real growth + 2% inflation), rather than 0% (1% to 2% real growth - 1% to 2% inflation). In a fragmenting global economy, Japan also appears to be in a good geopolitical position. In particular, it should benefit from the economic integration of the Eurasian region. Japanese companies are also often among the world leaders in their respective sectors. Their valuation is attractive, especially if we take into account the potential for improving the efficiency of their balance sheets. Their debt levels are also below those of their Western counterparts. It is important to note, however, that the Japanese market is a fairly cyclical one, and many Japanese companies would be affected in the event of a sharp slowdown in the global economy.

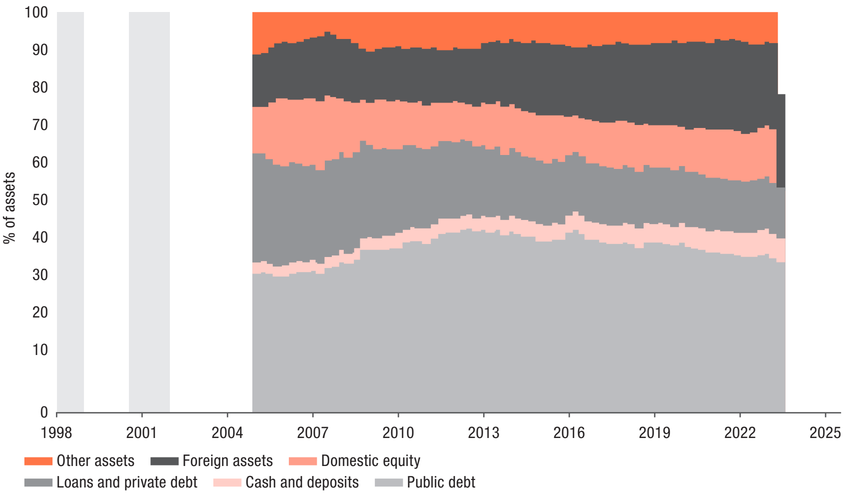
EVOLUTION OF THE EUR/JPY EXCHANGE RATE OVER 5 YEARS



Source: Macrobond/Bloomberg

For a euro investor, much of the good performance of the Japanese market in 2023 has been destroyed by the depreciation of the yen. The Japanese currency has depreciated by over 25% against the euro and the dollar since 2020.
At the root of this depreciation is the widening interest rate differential between these currencies and the yen. On the one hand, the US and European central banks have significantly tightened their monetary policies. On the other, the Bank of Japan maintained its policy of zero interest rates and yield curve control. The yen thus became a financing currency, with investors borrowing in this currency and then investing in other currencies. Things are changing, however. In Europe and the United States, monetary tightening seems to be over, and the authorities have indicated that they are considering rate cuts in 2024. In Japan, the new governor of the Bank of Japan has clearly hinted at a normalization of monetary policy. While it seems clear that interest rates in Japan will not return to American or European levels, the narrowing of the interest rate differential should benefit the yen at a time when the Japanese currency seems extremely undervalued.

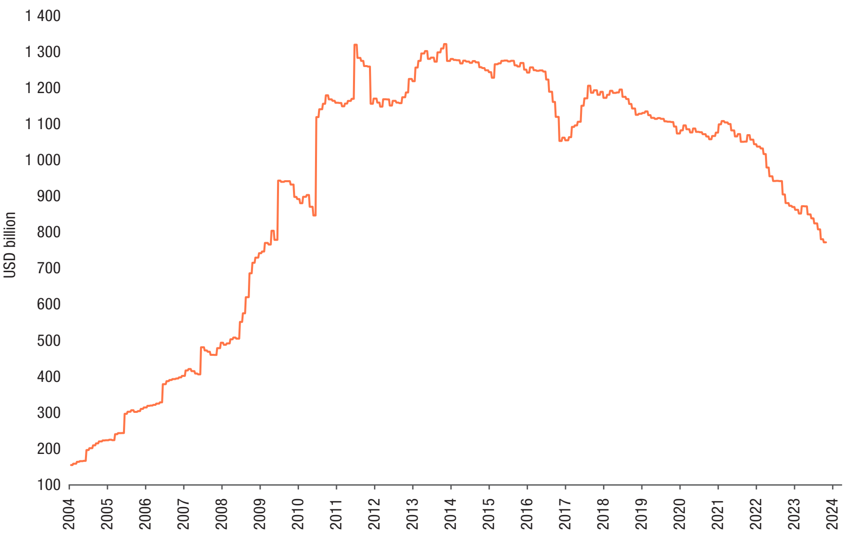
PERCENTAGE OF ASSETS HELD BY JAPANESE PENSION FUNDS AND INSURANCE COMPANIES INVESTED IN DOMESTIC EQUITIES



Source: Minack Advisors

Contrary to what one might expect, an appreciation of the yen and a rise in interest rates can be considered favourable to the stock market in the case of Japan. Firstly, they would encourage the repatriation of capital from abroad (Japan continues to record a significant surplus in its trade balance and remains a creditor country), which could then be invested in local assets. Many experts believe that a 10-year rate of 1% would enable pension funds and insurance companies to match their assets to their liabilities, thus reducing the incentive for these institutions to seek returns abroad. At the same time, both domestic and foreign investors remain very under-invested in equities. An appreciation of the yen would also not jeopardize corporate earnings. On average, exporting companies use an exchange rate of around 135 USD/JPY in their profit estimates. They are extremely competitive at the current rate of 150. A gradual and orderly appreciation of their currency would therefore not penalize them.

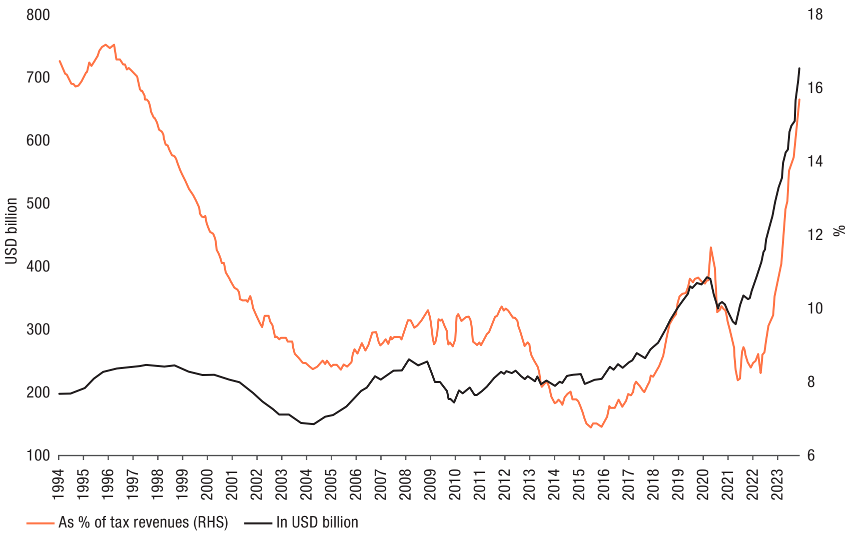
US GOVERNMENT BONDS HELD BY CHINA



Source: Jefferies

Bond markets were turbulent last year. After declining between January and March, the yield on the US 10-year government bond began a sharp rise until October, before falling sharply in the last two months of the year to end 2023 at almost the same level as it began. Much ado about nothing, except that fears of an imbalance between supply and demand for US government bonds have now truly emerged for the first time. On the supply side, the government's substantial and growing financing needs will be reflected in large-scale issuance of government bonds. On the demand side, a number of countries that were traditionally prepared to recycle their surpluses into US government bonds are not only no longer prepared to do so, but are beginning to reduce their positions. This imbalance between supply and demand is likely to gradually gain in importance. In the short term, however, a sharper-than-expected deterioration in US economic activity could stimulate demand for long-term Treasuries. In a recession, the Federal Reserve typically cuts its key interest rate by some 300 to 400 basis points. If this were to happen again this time, US long rates could temporarily fall back below 3%.

UNITED STATES: NET INTEREST PAYMENTS AS % OF TAX REVENUES



Source: Jefferies

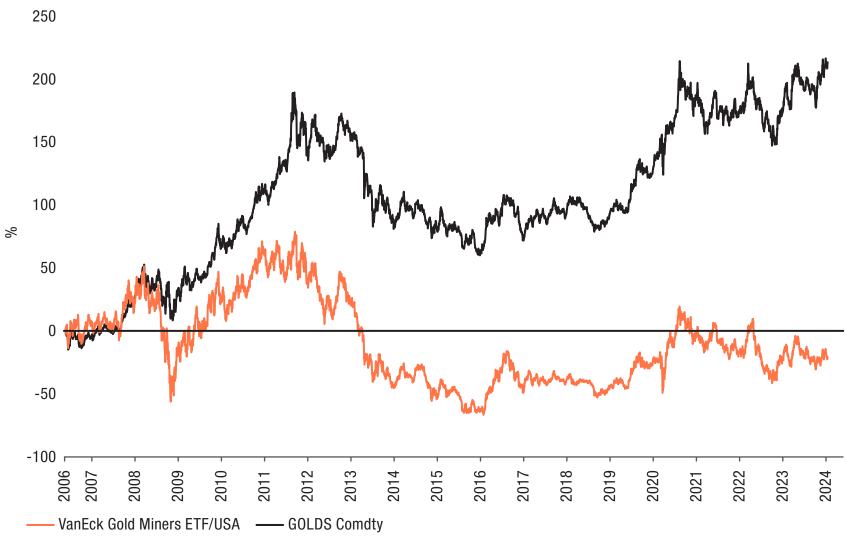
Another factor likely to limit any rise in interest rates is the cost of servicing the public debt. The rise in interest rates over the past two years has meant that the proportion of tax revenues that must be devoted to interest payments on the debt has risen from 8% to over 15%. Unlike companies, which took advantage of the period of low interest rates to refinance and extend the maturity of their debt, the government financed itself largely through short-term issues. More than half of US public debt will have to be refinanced by the end of 2026. It seems inconceivable that the political authorities would allow the cost of debt servicing to continue rising, thereby limiting their room for manoeuvre in other areas of public spending. This could lead to a return to a kind of financial repression, whereby interest rates would be kept below those justified by economic fundamentals. At the same time, a higher inflation rate could be tolerated by the authorities to gradually reduce the real cost of debt. After rising for the past 18 months, real rates (nominal rates adjusted for inflation) could then fall again. Such a scenario argues in favour of inflation-indexed bonds. No wonder the German government announced at the end of 2023 that it would stop issuing such bonds.

GOLD PRICE TREND

Source: Macrobond/Bloomberg

Gold continued its ascent in 2023, with the price of the yellow metal appreciating by more than 13% against the dollar and the euro. This rise may come as a surprise in a context of rising real interest rates. In the past, the price of gold was negatively correlated with real interest rates, which is logical given that the yellow metal does not pay interest. The rise in real interest rates in 2023 has indeed led to significant sales of gold by financial investors, as evidenced by the outflow of capital from gold exchange-traded commodities (ETCs). These outflows were, however, more than offset by the increase in physical demand, particularly from central banks. These purchases came mainly from eastern central banks. They reflect the growing mistrust of non-Western countries towards the dollar and American bonds, and the desire of these countries, starting with China, to set up an alternative to the current financial system based on the greenback. Gold therefore continues to move from West to East.

GOLD PRICE AND GOLD PRODUCER INDEX OVER 20 YEARS



Source: Macrobond/Bloomberg

The conditions for a continuation of gold's upward trend now appear to be in place. Physical demand should remain buoyant, and demand from financial investors could return with the anticipated easing of the Federal Reserve's monetary policy. This demand could prove all the more important given that any further rise in inflation would put central banks in the unpleasant position of having to choose between fighting inflation or limiting the cost of servicing their debt. As gold is a hedge against inflation in the monetary sphere rather than in the real economy, any return by central banks to much less restrictive monetary policies, or even to quantitative easing, would be likely to boost the price of the yellow metal. After a good start to the year, gold companies once again disappointed. Their underperformance relative to the metal can be explained in part by financial investors' lack of interest in the sector, but also by their rising costs, which often outstrip the rise in the gold price. Added to this is a certain mistrust of these companies on the part of investors, given their often disappointing track record in creating shareholder value. Nevertheless, their underperformance offers opportunities, provided one accepts the high volatility of this asset class.

Summary

In short, a certain complacency has set in on financial markets at the start of the year. Consensus analysts are expecting S&P 500 corporate earnings to rise by more than 10%, but at the same time believe that the Federal Reserve will cut its key interest rate by almost 150 basis points, ignoring the fact that such a monetary easing would not be necessary in an environment conducive to such earnings growth. In other words, the market is anticipating significant rate cuts, but seems to be dismissing the possibility of economic weakness large enough to justify such cuts. Geopolitical uncertainties and elections in the USA, and even in Taiwan, are other factors prompting a degree of caution, after the sharp rise in stock prices over the last few months of last year.

In the medium to long term, however, real assets should be favoured over monetary assets, and thus equities over bonds. Although central banks have been able to restore their credibility somewhat over the past two years, their window of opportunity to show great determination in the fight against inflation is closing. High levels of public debt and the need to finance growing public deficits are simply not compatible with high interest rates in real terms. Insofar as bonds and equities are the two main asset classes, the problems of one should benefit the other, notwithstanding the fact that the valuation multiples of most Western stock markets are certainly not low. That said, the risk of a much sharper-than-expected economic slowdown currently justifies an investment in government bonds.

The degree of concentration in the stock markets, with the USA accounting for some 70% of the world index and the Magnificent 7 for over 30% of the US index, is another reason for caution. However, it also offers opportunities for active management. Our preference is for quality defensive companies, for both bottom-up reasons (more attractive valuations) and top-down reasons (earnings less dependent on global economic conditions). On a regional level, the Japanese market should continue to benefit from favourable structural elements.

Gold continues to have its place in a balanced portfolio. The fact that the yellow metal was able to appreciate in 2023 despite rising real interest rates is a sign of its inherent strength.

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