N° 179

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Perspectives

Financial markets analysis

- The possibility of recession in the United States is still in the balance.
- After the considerable slowdown in inflation over the past 18 months, a return to the 2% target looks more problematic.
- Despite the tenacity of inflation in the services sector, the US and European central banks are indicating interest rate cuts in the coming months.

- The gap between what equity markets are pricing in and what is happening.
- Notwithstanding the possibility of a more or less significant correction, equities of quality companies should be preferred to government bonds.
- Japan and gold remain among our strongest convictions.

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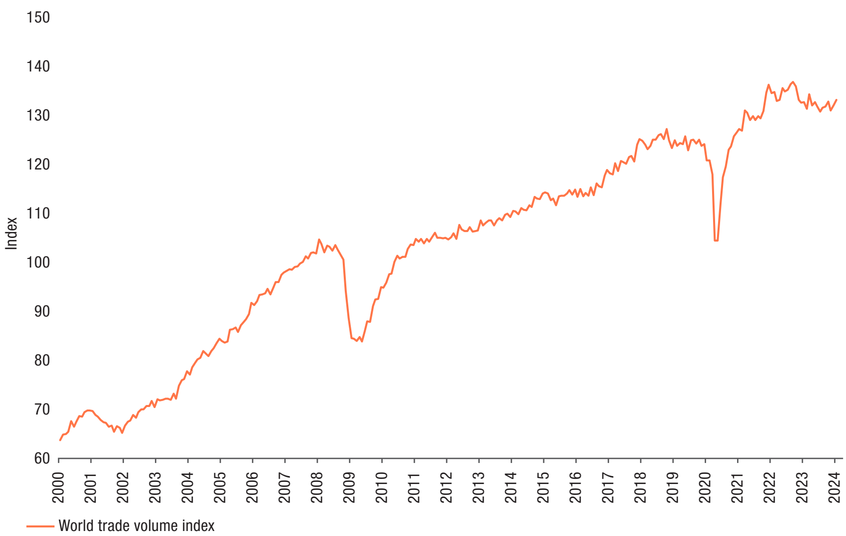
Macroeconomic environment

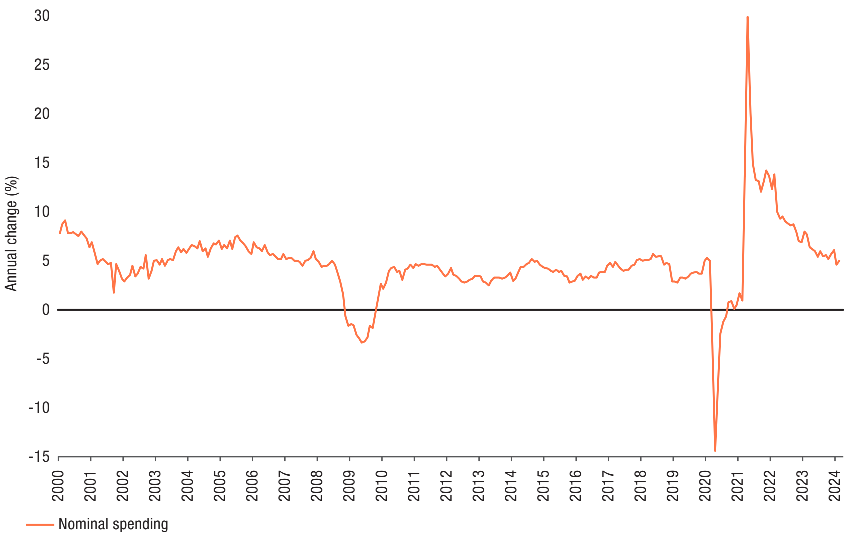
GLOBAL TRADE



Source: CPB Netherlands Bureau for Economic Policy Analysis, Bloomberg

There has been little change in the global economic situation since the start of the year. Overall, the pace of growth remains weak, with no signs of excessive deterioration. The United States continues to be the most robust region, with domestic consumption maintaining its resilience during the first quarter. The eurozone is flirting with recession. Countries that are heavily dependent on the manufacturing sector, such as Germany, are under particular pressure, while the southern countries, buoyed by the boom in tourism, are faring much better. In China, activity has been sustained in recent months by government measures that are showing initial positive effects on both industrial output and household consumption. However, structural overcapacity in the property sector and geopolitical tensions with the United States are continuing to impact the general business climate and preventing a return to confidence within the country. In Japan, negative wage growth in real terms is weighing on household demand, which explains the weakness of growth in the second half of last year.

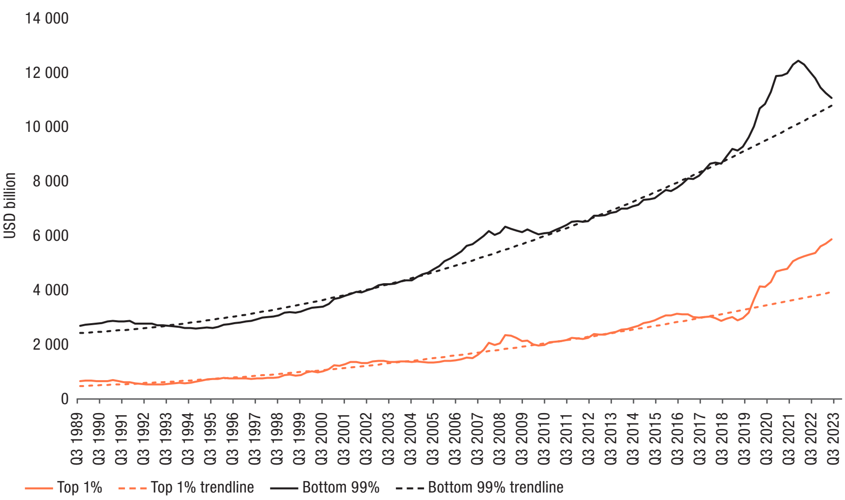
CONSUMER SPENDING IN THE US



Source: Bureau of Economic Analysis, Bloomberg

In the United States, economic activity is maintaining a fairly robust cruising speed despite the Federal Reserve's hike in key interest rates since March 2022. The recession scenario – which history suggests is the inevitable consequence of the inversion of the yield curve, the decline in the Conference Board's Composite Index of Leading Indicators and the significant slowdown in credit activity – has not materialised so far. Although the final verdict has not yet been delivered, it is worth noting that the historical maximum lag of 18 months between the start of inversion of the yield curve and the onset of recession expires in April. Proponents of the absence of contraction thesis point to a gradual reduction in the cyclicality of economic activity, given the growing share of services activities. Already, in the 2001 recession, domestic consumption had not posted a single quarter of decline, testifying to the stability the economy has developed over time. If GDP growth is still positive after the summer, the no-recession thesis despite the inversion of the yield curve would seem to be definitively validated.

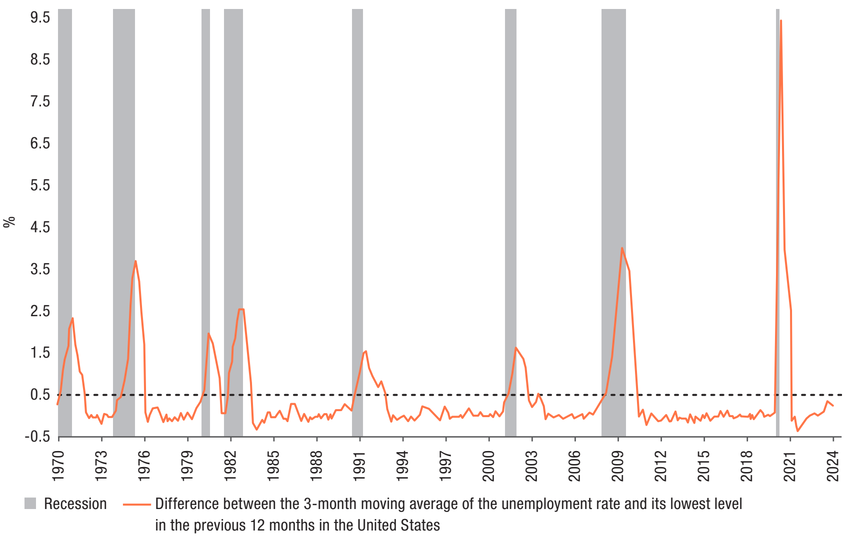
US HOUSEHOLD BANK DEPOSITS AND MONEY MARKET FUND INVESTMENTS



Source: Federal Reserve, BLI

A detailed analysis of the liquidity held by American consumers suggests that the main factor behind the absence of recession in the US is the excess savings created during the pandemic. At the end of 2021, the surplus savings of US households (excluding the wealthiest percentile), defined as the difference between current savings and their extrapolated 30-year trend, amounted to $2,300 billion, representing almost 8% of GDP. Of this $2,300 billion, $1,300 billion has since been spent, representing 4.5% of GDP, which is more or less equivalent to all the economic growth of the last two years. After this period of over-consumption, household savings have returned to their long-term trajectory, suggesting that the period of excessive spending is now over. If the savings rate does not continue to fall, the rise in wages will not be enough to prevent a decline in domestic consumption. The recent high increase in credit card lending also suggests that current incomes are no longer sufficient to meet current consumption needs.

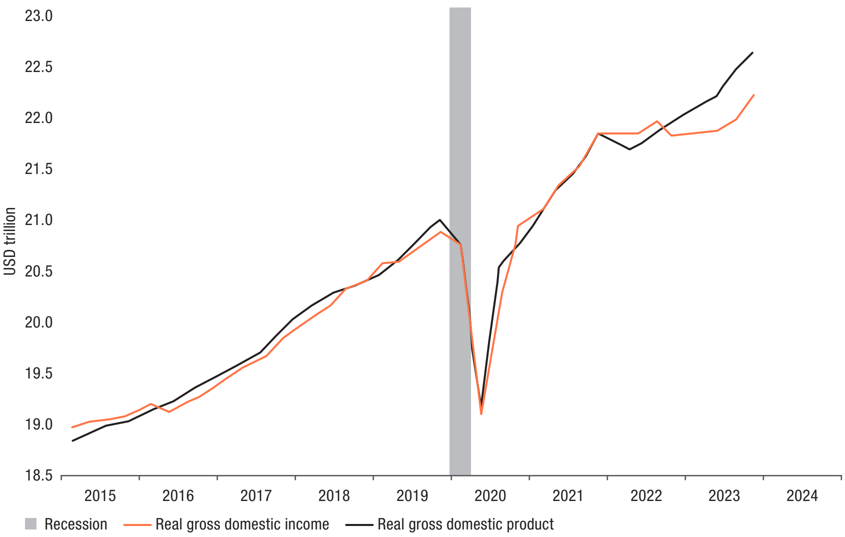
SAHM RULE RECESSION INDICATOR



Source: Federal Reserve Bank of St. Louis, Claudia Sahm, Jefferies

Despite the resilience shown by the job market so far, recent statistics paint a mixed picture. On the one hand, the decline in voluntary layoffs, reduction in the number of hours worked and fall in temporary positions are generally seen as warning signs of a deeper deterioration in the labour market. On the other hand, claims for unemployment benefits have not risen and the unemployment rate remains low overall. Historically, when the 3-month moving average of the unemployment rate has been 0.5% above its lowest point of the previous 12 months, the economic cycle has always ended in recession. Currently, 20 out of 50 US states already meet this criterion, known as the Sahm Rule, established by former Federal Reserve economist Claudia Sahm. When the latest employment figures were published at the beginning of April, the difference between the 3-month moving average of the unemployment rate and its previous 12-month low was 0.4%, confirming that the US economy is not (yet) in recession.

GDP AND GDI IN THE UNITED STATES



Source: Piper Sandler

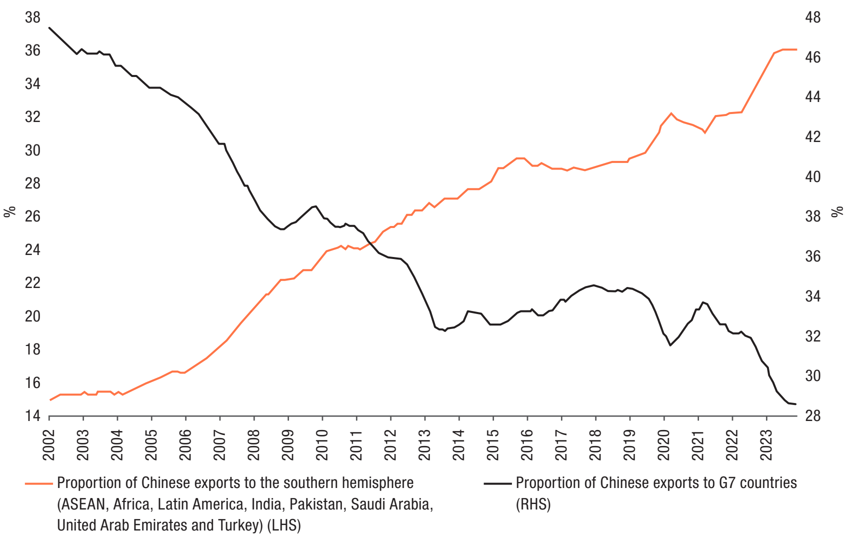
A worrying factor that often heralds a future economic slowdown is the divergence in statistics that theoretically measure the same economic aggregates. For example, gross domestic income, which includes all incomes such as wages, corporate profits, dividends, interest and rents, should by definition correspond to gross domestic product, which reflects the total value of the production of goods and services over the course of a year. At present, however, the sum of incomes remains lower than the total value of production, for no apparent reason. This will need adjusting up or down at some point in the future. Similarly, surveys conducted among businesses to assess the state of the labour market paint a slightly different picture to that obtained from household surveys. For example, the number of new jobs created according to the business survey is significantly higher than the number of new hires according to the household survey. These divergences cast doubt on the US economy's capacity to maintain its current growth rate and hence avoid recession in the second half of the year.

COMPENSATION PER EMPLOYEE IN THE EUROZONE

Source: Piper Sandler

The eurozone is among the regions with the least attractive growth prospects. Although a technical recession, characterised by two consecutive quarters of falling activity, was narrowly avoided in the second half of 2023, many public and private institutions are continuing to downwardly revise their growth expectations for the eurozone this year. Furthermore, industrial production is still declining, under the impact of weak external demand and loss of competitiveness due to rising energy costs. At the same time, the property sector is suffering from rising interest rates, leading to a slowdown in construction activity in most countries. The impetus given to services activities by the post-pandemic reopening of the economy has also lost momentum, with European consumers not benefiting from such substantial public support as their American counterparts. The main hope for an improvement in the economic situation this year lies in falling inflation and sustained wage growth, which should lead to an increase in household purchasing power in real terms, and consequently an acceleration in consumer spending, provided that the employment market does not deteriorate first.

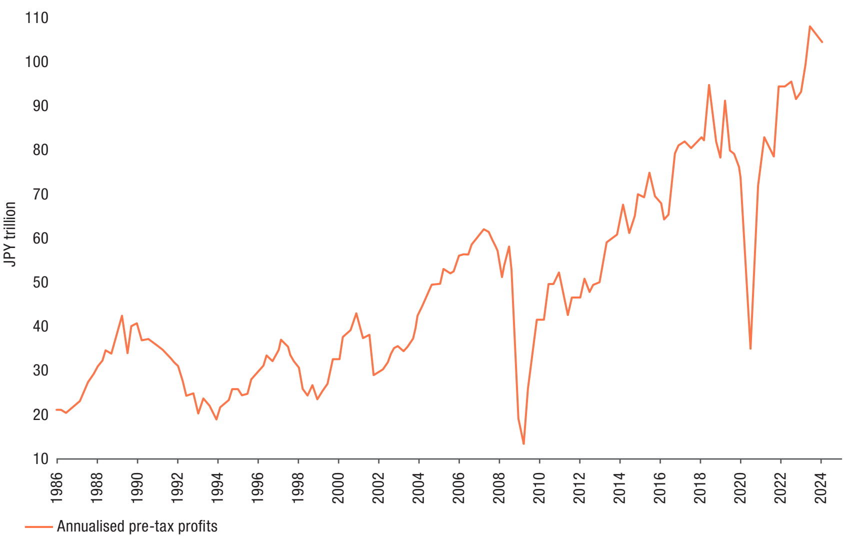
CHINESE EXPORTS



Source: CEIC, General Administration of Customs, Jefferies

Economic growth appears to be normalising in China, supported by a series of one-off stimulus measures. The Beijing authorities are trying to establish a GDP growth rate of around 5% through a prudent and balanced management policy. The structural slowdown in Chinese growth is the logical consequence of the country's development trajectory, with the deceleration in the growth rate appearing to follow a similar pattern to that seen in Japan and South Korea, once their GDP per capita had passed the 7,000 dollar threshold. Despite major challenges such as geopolitical tensions, overcapacity in the property sector and a stagnating population, the Chinese economy still has considerable long-term growth potential. Ongoing urbanisation, booming trade with the southern hemisphere, massive investment in infrastructure, technological innovation and the vast potential for expansion of the domestic market are among the Chinese government's favoured development paths. Perseverance and long-term vision should enable China to continue its economic ascent despite the current headwinds.

JAPANESE CORPORATE PROFITS



Source: Piper Sandler

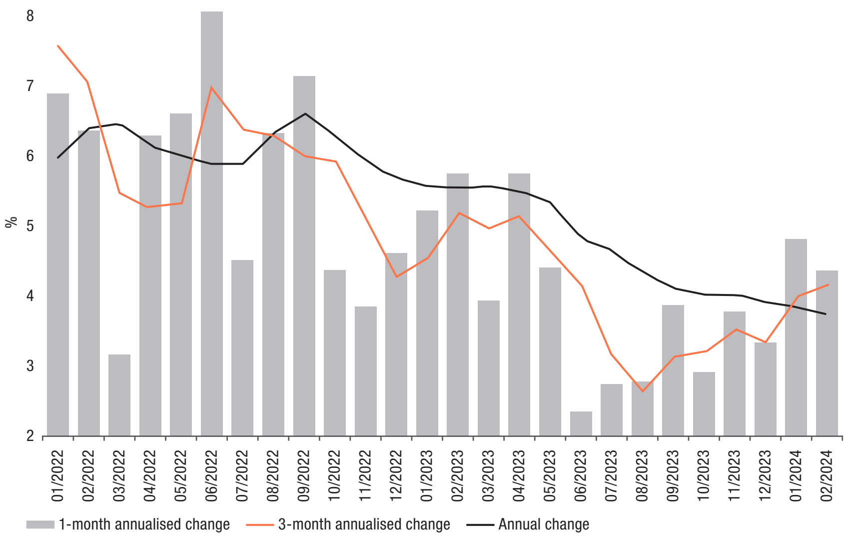
Despite reaching the most favourable wage agreements for 30 years in the spring of 2023, Japanese household incomes ended up growing below inflation throughout last year, which weighed on economic growth in the second half. This year, early indications point to even more substantial wage hikes, ensuring above-inflation adjustments and consequently an increase in household purchasing power in real terms. The very sound financial position of Japanese companies enables them to bear higher wage costs without having to cut back on investment. Thanks to the weak yen, which makes them highly competitive, and low levels of debt, they are generating strong earnings growth and record profit margins. In addition, households and businesses will benefit from the ongoing highly accommodative monetary policy, despite the Bank of Japan recently ending its policy of negative interest rates and control of the yield curve. The monetary authorities seem very reticent about the idea of a further rise in the price of money and have not given the slightest signal about a possible reduction in purchases of government bonds, even though they already hold more than 50% of the total stock of government debt on their balance sheet.

CRUDE OIL PRICE

Source: Bloomberg

Now that inflation has fallen from the high levels seen in 2022, further easing of price rises looks more problematic. The current downward trend in inflation could be reversed by a rise in oil prices due to the growing risk of an imbalance between supply and demand. On the one hand, the possible acceleration in the Chinese economy and a recovery in global industrial production (as suggested by the recent improvement in manufacturing sector activity indices in several countries) could lead to an increase in demand. At the same time, the extension of the agreement by OPEC+ members to maintain production cuts until mid-2024 and uncertainties over the ability of the US oil sector to increase shale oil exploration could prevent an increase in supply, at a time when the US strategic petroleum reserve remains at a low level. Added to this are geopolitical uncertainties, such as the risk of expansion of the conflict in the Middle East or Vladimir Putin's possible efforts to drive up oil prices ahead of the US presidential elections to promote victory for Donald Trump. As a result of the now unfavourable comparison basis, any rise in oil prices would immediately lead to a reacceleration in inflation rates.

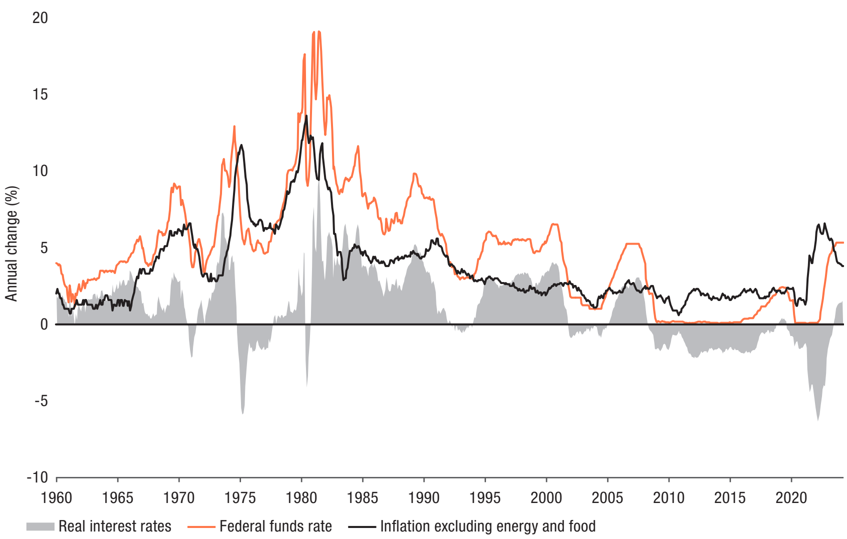
INFLATION EXCLUDING ENERGY AND FOOD IN THE UNITED STATES



Source: Bureau of Labor Statistics, Jefferies

Even without a hike in oil prices, the tenacity of inflation in the services sector is a major obstacle to inflation returning to around 2%. In the very short term, US inflation statistics have already deteriorated. All price indicators are showing an acceleration in their annualised change over one or three months, reversing the downward trend that had set in until December last year. Even year-on-year, inflation in goods and services excluding energy and food seems to be persisting at 3% to 4%, depending on the type of indicator used. If the US economy remains resilient and avoids contraction, and the labour market remains firm, it will be difficult for inflation to return to 2%. Moreover, the longer the growth cycle continues, the greater the likelihood that goods inflation, currently close to zero, will accelerate again, if it hasn't already, because the comparison bases have become very low. In short, as long as the economic situation manages to defy the economic laws of the past by avoiding recession despite such significant monetary tightening, there is no certainty that inflation will continue to slow.

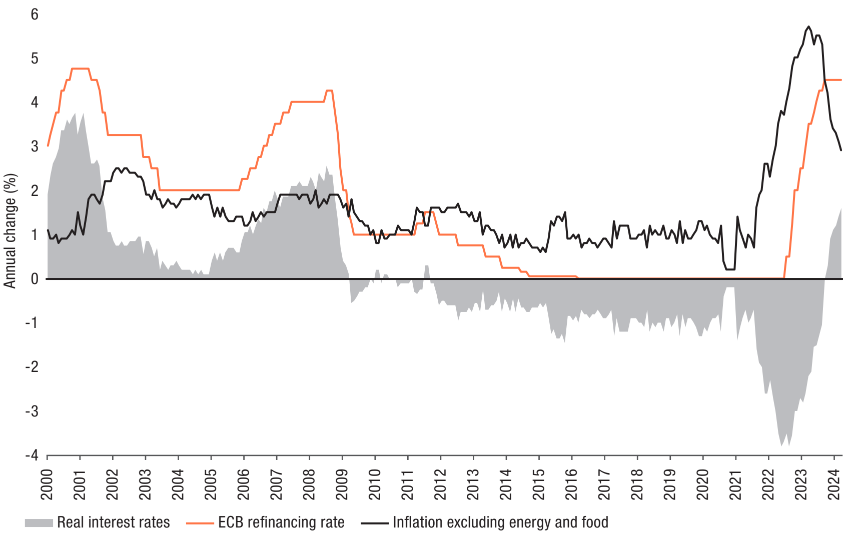
US MONETARY POLICY



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

The US Federal Reserve has left its key interest rates unchanged since July 2023, and the target range for the Federal funds rate remains 5.25%-5.50%. Given the resilience of the US economy on the one hand and falling inflation on the other, the Fed has so far opted for a status quo monetary policy. Meanwhile, Fed Chair Jerome Powell has prepared the market for the gradual easing of monetary conditions, which he plans to initiate once he feels sufficiently confident that inflation will return to the 2% target on a sustainable basis. Somewhat mixed price statistics since the start of the year have not prevented Powell from maintaining his guidance, as he considers the downward trend in inflation that began in the second half of 2022 is still in place, even if the final stage to the 2% target is likely to prove rather trickier. The market is currently expecting three interest rate cuts between now and the end of the year (corresponding to the FOMC's official projections), with the first expected at its June meeting. The date of the presidential elections in November is another factor in favour of an initial move on rates in June, with a view to maintaining a stable economic environment over the summer, which would favour neither the challenger nor the outgoing president.

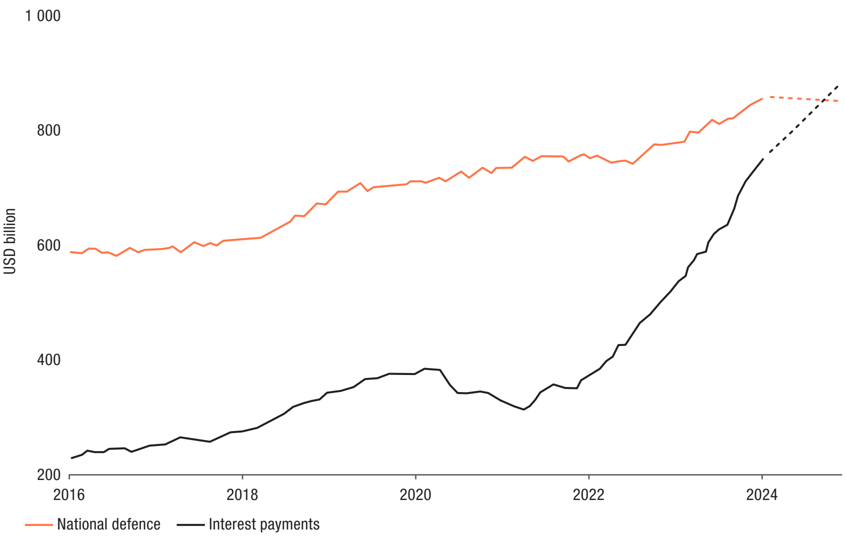
EUROZONE MONETARY POLICY



Source: European Central Bank, Eurostat, Bloomberg

The ECB has left its key rates unchanged since September 2023. Since then, its refinancing rate has been 4.5% and its deposit rate 4%. The European monetary authorities are in a more awkward situation than their American counterparts. On the one hand, the weakness of the economy in general and the construction sector in particular would justify lower interest rates, which would help to stimulate activity. On the other hand, core inflation is still close to 3%, and wage rises of around 4% to 5% raise doubts about any premature easing that might lead to a reacceleration in price rises. Added to this is the fact that, unlike the Federal Reserve's mandate, that of the ECB is solely focused on price stability, not full employment. Faced with this dilemma, the ECB has a delicate balancing act on its hands. Currently, its president Christine Lagarde is indicating a first rate cut in June, hoping that inflation will continue to fall between now and then. If eurozone monetary policymakers do indeed act in this way, it would be one of the rare occasions when European interest rates pivot ahead of US rates. This could have a negative impact on the value of the euro, and consequently on the level of imported inflation.

US FEDERAL SPENDING

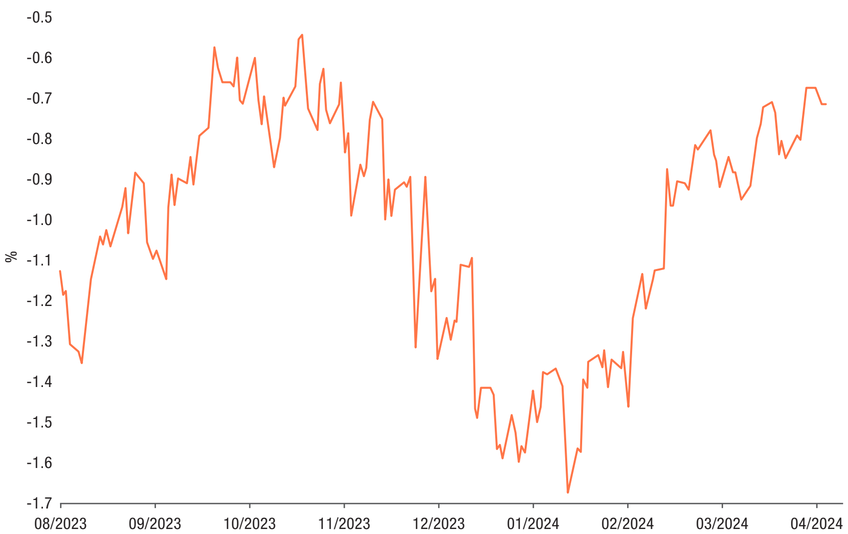


Source: Evercore ISI

Even if the US economy, the engine of global growth, succeeds in avoiding recession, most of the components of GDP offer little prospect of growth for the rest of the year. With unemployment at record lows, the potential for improvement in the labour market is virtually nil. Since profits have stagnated over the past two years, a strong acceleration in business investment also seems unlikely. Likewise, companies will be reluctant to increase wages any further, as this would push up inflation and, consequently, interest rates. An acceleration in productivity gains is a possibility in the long term after a prolonged period of high investment, but unlikely in the short term after a decade dominated by share buybacks. That leaves public spending, which seems to have become the ultimate source of growth, easily activated because it is supported by the Federal Reserve. Nevertheless, the rise in interest rates has already considerably increased the cost of the public debt burden, with the level of interest payments probably exceeding the entire expenditure allocated to national defence this year. In other words, a continuation of the current growth cycle only looks feasible at the cost of further deterioration in the already severely battered public finances.

Financial markets

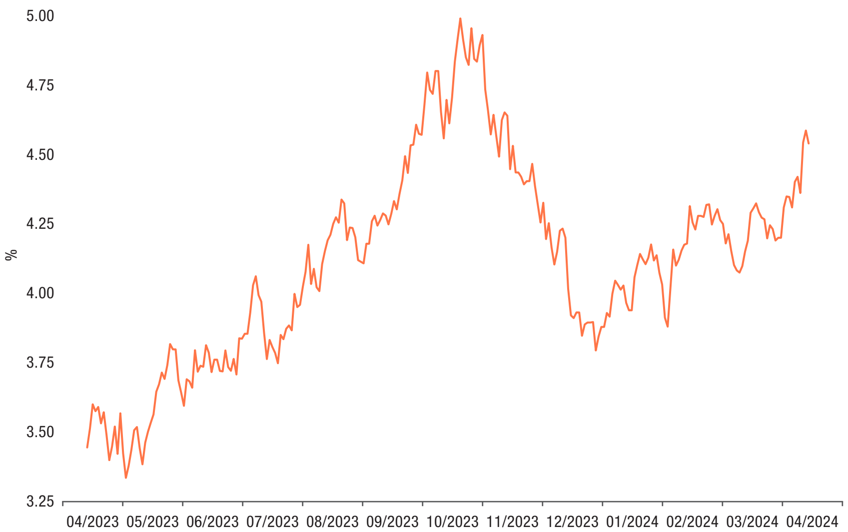
FED FUNDS FUTURES IMPLIED RATE CUTS BY THE END OF 2024



Source: Bloomberg, Jefferies

Stock markets continued to rise in the first quarter, driven by growth stocks. The global index rose by 8.9% in USD and 11.3% in EUR. The fact that investors had to lower their expectations of monetary easing by the Federal Reserve did not dampen their enthusiasm for equities. Investors believe that an environment where rates remain higher than expected due to more robust economic growth is ultimately positive for equities. What's more, the President of the US Federal Reserve continues to talk in an accommodating tone, pointing to a first rate cut in the middle of the year. In local currency terms, the Japanese market was the best performer, but the continued rise in the prices of the 'Magnificent 6' enabled the US market to outperform the European market. In terms of sectors, real estate, basic materials and utilities were the worst performers, while the global semiconductor index gained over 35%.

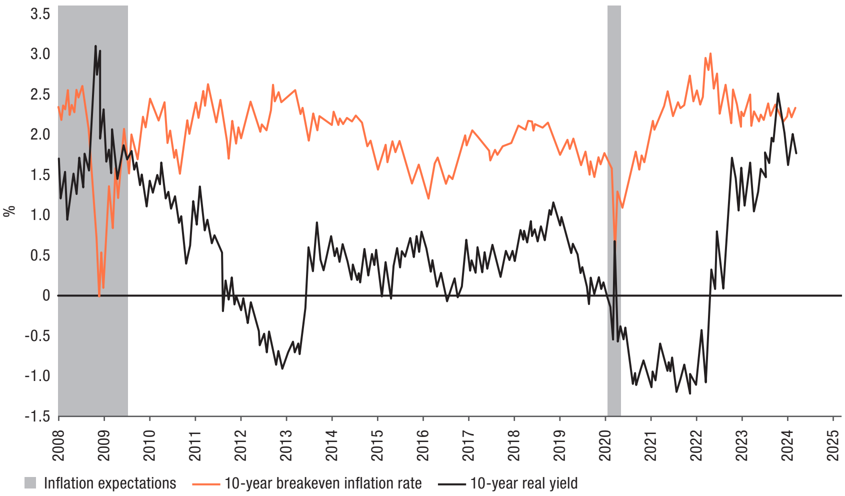
US 10-YEAR GOVERNMENT BOND YIELD



Source: Macrobond/Bloomberg

The first quarter was less favourable for bond markets. Stronger growth and somewhat unfavourable inflation figures reduced investors' expectations of a loosening of central banks' monetary policies, leading to a rise in bond yields. After declining over the last two months of last year to end the year at 3.9%, the yield on the 10-year US government bond climbed back up to 4.4% at the beginning of April. The possibility of the US economy slipping into recession now seems to have been definitively ruled out by the markets. The fact remains, however, that behind the positive figures on which investors are focusing lies a deterioration in economic activity, a deterioration which seems logical given the sharp rise in interest rates over the past two years. If this deterioration were to become more visible, high-duration government bonds would regain their safe-haven role. In a recession, the Federal Reserve traditionally cuts its key rate by 300 to 400 basis points. If it were to do so again, this rate would fall below 2% and long-term government bond yields below 3%.

UNITED STATES: 10-YEAR REAL YIELD AND INFLATION EXPECTATIONS



Source: Bloomberg, NBER, Minack Advisors

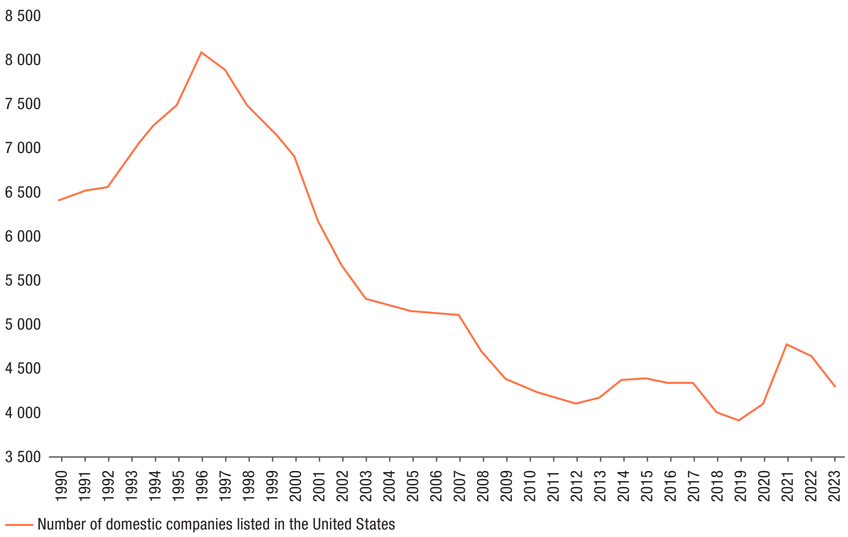
In the longer run, however, central banks may have to choose between fighting inflation on a long-term basis or allowing governments to finance themselves and limit debt servicing costs. An ageing population and ambitious public programs (social spending, energy transition, rearmament, etc.) will continue to weigh on public spending, which is likely to grow faster than tax revenues. As a result, budget deficits will continue to rise, while public debt is already high. At the same time, some of these programs are highly resource-intensive, both in terms of manpower and raw materials. This at a time when, between an ageing population and under-investment in mining projects, the global economy seems to be entering an era of scarcity of these resources. The imbalance between supply and demand will normally lead to an increase in their price, and thus to more inflation. The combination of higher inflation and the need to keep interest rates relatively low will lead to a fall in real interest rates, from which inflation-linked bonds will benefit.

EMERGING MARKET LOCAL CURRENCY RELATIVE TO G7 GOVERNMENT BOND INDEX

Source: Bloomberg, Jefferies

The strong rise in interest rates by central banks since 2022 has made certain segments of the bond markets more attractive once again. The creditworthiness of high-yield issuers is now once again based on their fundamental quality, rather than on central bank liquidity injections. As the geopolitical and economic context has become much more uncertain, an approach based on the intrinsic characteristics of high yield issuers allows oneself to detach from short-term macroeconomic forecasts. As for the credibility of sovereign issuers in emerging countries, it has been strengthened by their ability to respond to a succession of crises of various kinds over the past four years. In this respect, it is worth noting the strong outperformance in $ terms of emerging country bond markets versus with those of industrialized countries since the 2020 pandemic, despite the appreciation of the greenback. This outperformance is due to much more orthodox monetary and fiscal policies.

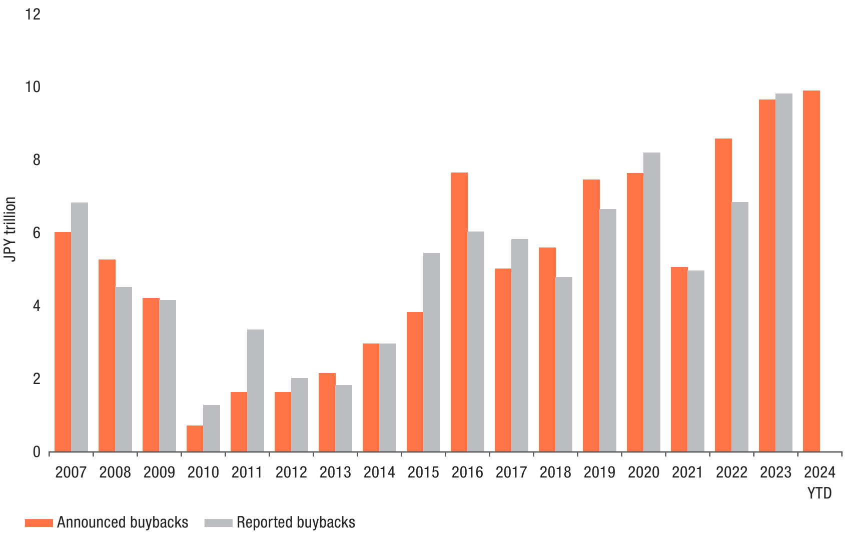
NUMBER OF DOMESTIC COMPANIES LISTED IN THE UNITED STATES



Source: World Bank, World Federation of Exchanges, Jefferies

Notwithstanding the possibility of a more or less significant correction, the economic environment continues to argue in favour of real assets over monetary assets and therefore equities over bonds, and more specifically quality stocks over government bonds. The persistence of high budget deficits will lead to an increase in government bond issuance, and there will come a time when demand will be lacking and it will be necessary either to use the regulatory framework to force certain investors to buy these bonds, or to ask central banks to do so. The supply of quality equities, on the other hand, is only diminishing as a result of acquisitions and buybacks. Quality companies also are in a better position to adapt to changes in the economic environment. What's more, they generally pay attractive and rising dividends, unlike bond coupons, which are fixed. As a result, they offer better protection against inflation.

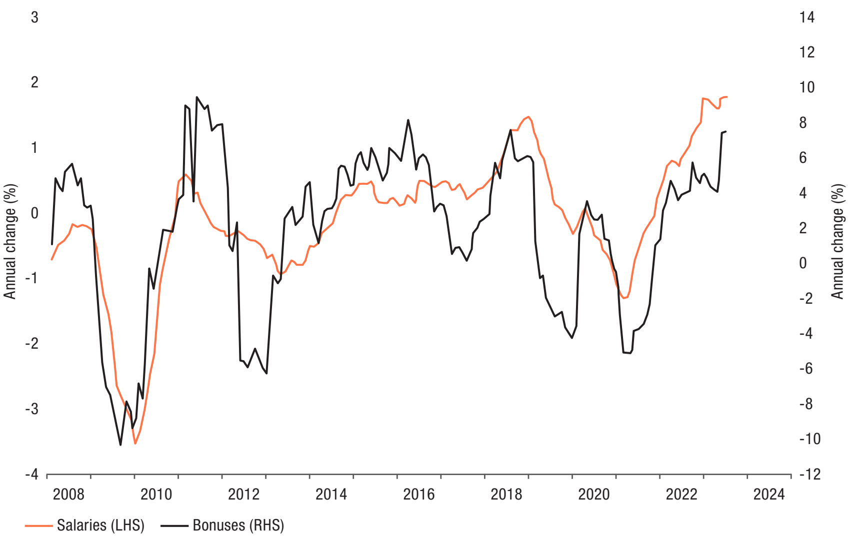
SHARE BUYBACKS BY JAPANESE COMPANIES



Source: Factset, Bloomberg, Jefferies

Among the major stock markets, the Japanese market was once again the best performer in the first quarter. We have repeatedly stressed the arguments in favour of this market. The main argument is the improvement in corporate governance. For decades, Japanese companies have been highly efficient in their operations, but have neglected their capital allocation, their priority being to win market share. As a result, their profit margins and return on capital employed were significantly lower than in other regions, starting with the USA, where the principle of shareholder value is paramount. All this began to change more than ten years ago with the Abenomics program introduced by former Prime Minister Shinzo Abe. Today, things are accelerating, with the arrival of numerous activist shareholders. The potential for improving profitability remains significant, making Japan one of the most interesting markets for the years ahead.

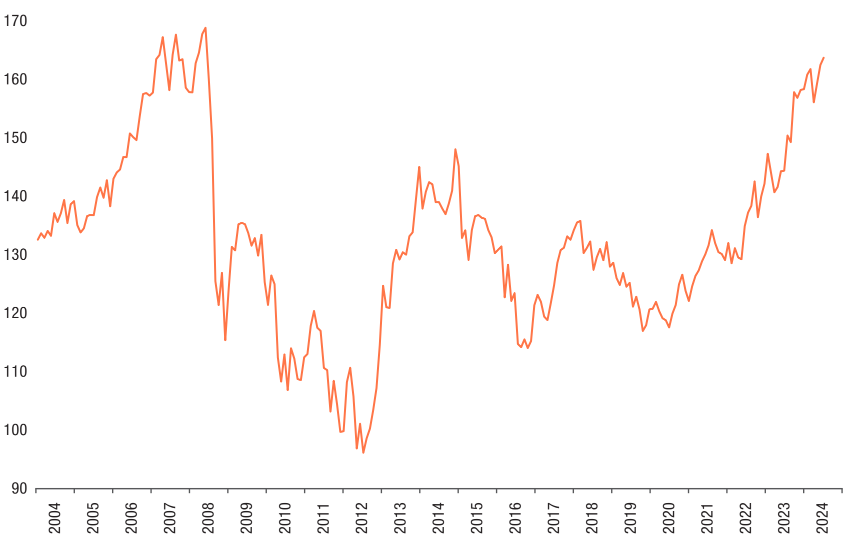
ANNUAL VARIATION IN SALARIES AND BONUSES IN JAPAN



Source: BCA Research

Another factor in the Japanese market's favour is the improving economic environment. For many years, the country's economy had to contend with deflationary pressures. While real growth in Japan was relatively similar to that of most other Western countries, nominal growth was much weaker, penalizing Japanese companies' revenue growth. Today, the country seems to have emerged from deflation and begun a virtuous circle of wage growth, productive investment, increased purchasing power and productivity gains. There are therefore many factors currently in favour of the Japanese market, but the equity weighting of institutional investors remains low. On the negative side, a sharp deterioration in global economic conditions would have a major impact on the Japanese market.

EUR/JPY EXCHANGE RATES



Source: Macrobond/Bloomberg

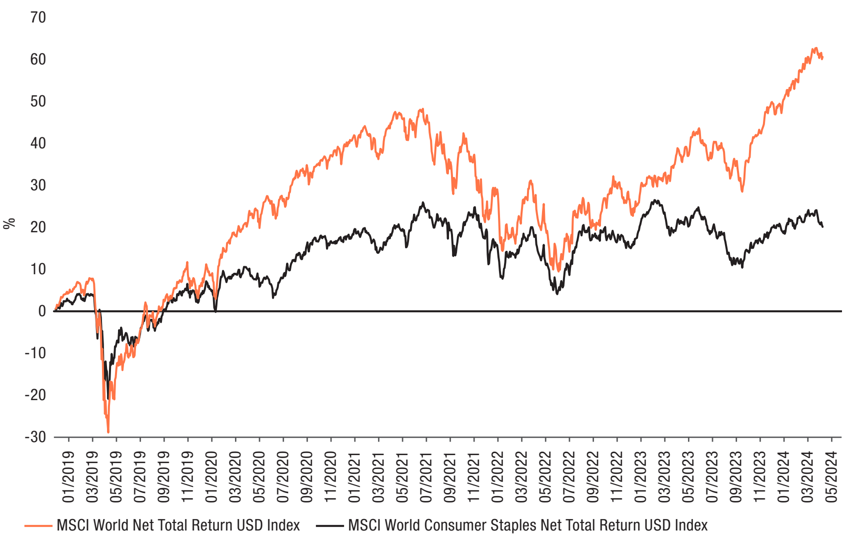
As in the past two years, part of the good performance of Japanese equities has once again been destroyed by the depreciation of the yen. Since the beginning of the year, the Japanese currency has fallen by 5% against the euro. This decline occurred despite the slight tightening of monetary policy by the Bank of Japan, which ended its negative interest rate policy in March. However, the yen's depreciation should come to an end, and the Japanese currency should appreciate again in the medium term. Firstly, the interest rate differential with the dollar and the euro will narrow as the Federal Reserve and European Central Bank loosen their monetary policies and Japan (timidly) tightens its monetary policy. To the extent that interest rates remain lower in Japan than in the West, this differential will remain unfavourable to the yen. Nevertheless, it is likely that the trend in interest rates will prevail over their absolute level. All the more so as the yen is currently largely undervalued and Japan remains the world's largest creditor. The potential for capital repatriation is therefore considerable, especially as only a slight rise in rates would be sufficient to enable domestic institutional investors to match their assets and liabilities.

GLOBAL SEMICONDUCTOR INDEX

Source: Macrobond/Bloomberg

Momentum strategies continue to dominate equity markets, with investors buying the stocks and sectors that have risen the most, starting with technology and semiconductors. One would have thought that the rise in interest rates over the past two years would lead the markets to place greater emphasis on valuations once again, but this has so far not been the case. Clearly, a sector like technology will continue to benefit from favourable secular trends such as digitization, artificial intelligence or cloud computing, and thus capture the imagination of investors. However, this does not justify paying any price, especially as the sector is characterized by rapid change, making long-term forecasts difficult.

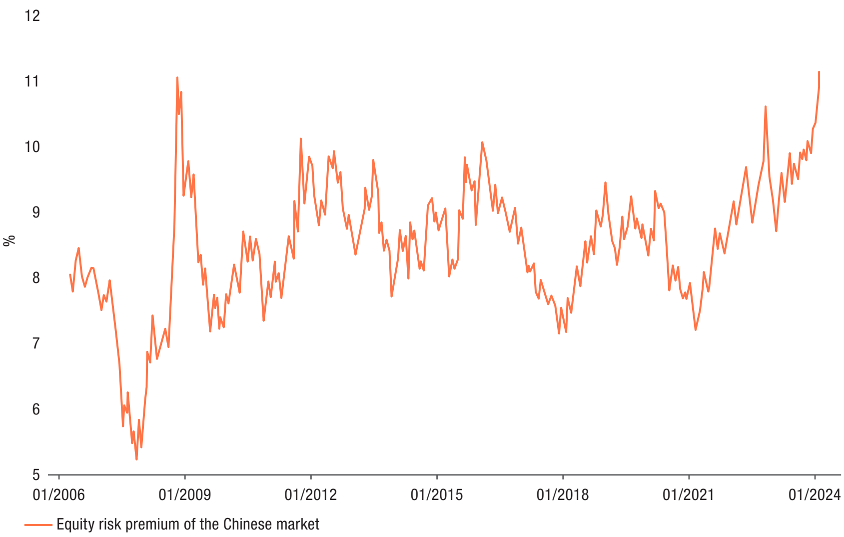
5-YEAR TREND IN CONSUMER STAPLES SECTOR AND GLOBAL INDEX



Source: Macrobond/Bloomberg

At the other extreme, sectors such as healthcare and consumer staples are being neglected. Among the 5 worst-performing stocks in the European STOXX 600 index in the first quarter were Roche, Nestle and Reckitt Benckiser. With the market consensus now expecting a soft landing or even a reacceleration of the US economy, investors see no reason to hold these sectors, traditionally considered defensive given their stability and resilience in times of economic recession. Despite their outperformance in the bear market of 2022, they have largely underperformed the global index over the past 3 years, and are now attractively valued. The ability of companies in these sectors to protect their profit margins and pay recurring and rising dividends is another factor in their favour, even if the dividend aspect clearly doesn't come into play in the current market context where momentum-based strategies prevail.

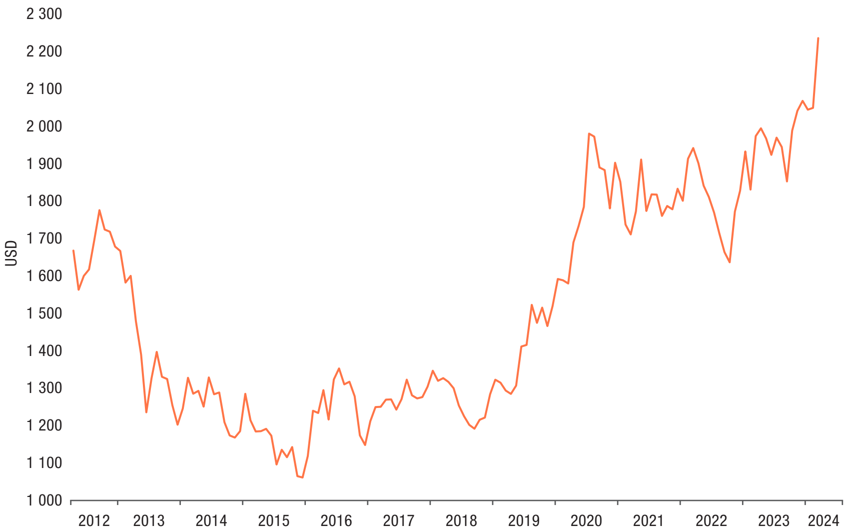
EQUITY RISK PREMIUM OF THE CHINESE MARKET



Source: CLSA, IBES, Bloomberg, MSCI

In terms of regions, the Chinese and Hong Kong markets continue to lag behind. Gloomy economic activity in China and geopolitical tensions continue to weigh on these markets. Some investors are no longer willing to invest in Chinese assets, believing that the rules of the game can change at any time at the whim of the Communist Party, and that the treatment of minority shareholders is uncertain. Clearly, the Chinese market is not the American market, and the Party's objectives take precedence over those of shareholders. This does not mean, however, that the two are necessarily irreconcilable. On the contrary, the political authorities need a dynamic private sector to achieve their growth objectives. As far as geopolitical tensions are concerned, it's important to note that, unlike Russia, China is highly integrated into the global economy and manufactures many of the products that the West needs. Meanwhile, Chinese equities offer a higher risk premium than was the case during the financial crisis, testifying to their attractive valuation.

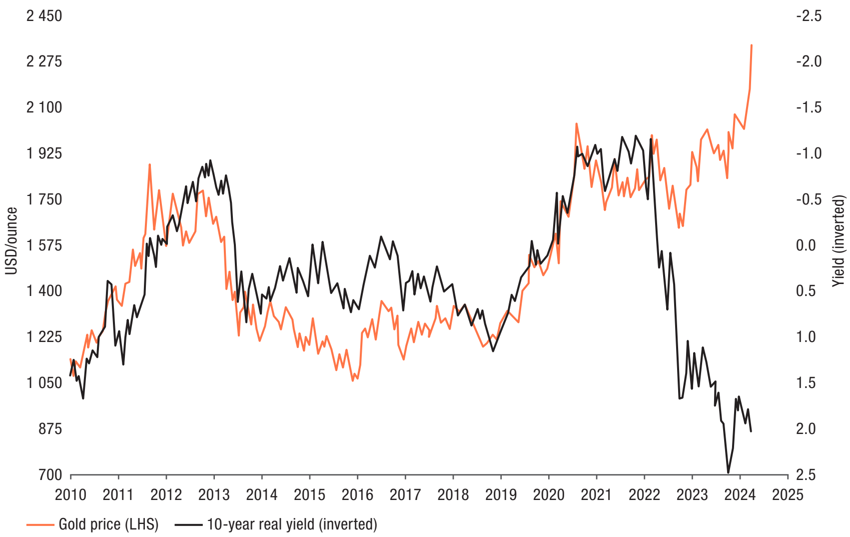
GOLD PRICE



Source: Macrobond/Bloomberg

The price of gold continues to rise, approaching $2,400 in early April. The rise in the price of the yellow metal has more to do with geopolitical than financial considerations. The fragmentation of the global economy and the establishment by China and its allies of an alternative to the current dollar-based financial system are boosting gold. Official purchases by these countries are not price-sensitive and are part and parcel of a strategy to recycle their trade surpluses through channels other than US Treasuries, which have lost their lustre as safe, neutral assets. Their efforts to reduce exposure to the US dollar are still in their infancy. As a currency, the yellow metal, whose supply is limited, also benefits from the fact that it presents no counterparty risk and from a growing mistrust of paper currencies. And despite its recent rise, the price of gold remains well below the peaks reached in 2011 and 1980 in real terms.

GOLD PRICES AND REAL RATES



Source: Bloomberg, NBER, Minack Advisors

A possible return of financial demand would prolong or intensify gold's rise. As mentioned above, it is essentially central bank purchases that have enabled the yellow metal to overcome its historical correlation with real rates (interest rates adjusted for inflation). As gold does not pay interest, a rise in real rates normally affects it in a negative way. And between rising interest rates and falling inflation, real rates have risen sharply since 2022. This has had a negative effect on financial demand for gold, as evidenced by outflows from gold exchange-traded funds (ETCs). This decline in financial demand also explains why gold companies have performed significantly worse than gold: central banks buy the metal, not the shares of gold companies. Between the willingness of central banks to loosen monetary policy and a structurally more inflationary environment, real interest rates are set to fall over the medium term, and financial demand should return.

FRANCO NEVADA SHARE PRICE SINCE INITIAL PUBLIC OFFERING

Source: Macrobond/Bloomberg

Royalty companies offer exposure to gold without the operational risks associated with conventional producers. They generally receive a percentage of the gold produced by a mining operation in return for initial financing. Their revenue stream can therefore be considered relatively stable, insofar as it is linked to the production of a mine, rather than its profitability. Royalty companies also receive their revenues from a large number of projects, which reduces their exposure to geopolitical risk. History shows that, over the long term, the performance of these companies is far superior to that of gold, unlike that of conventional producers. However, this was not the case in 2023, when the rise in the gold price was essentially due to purchases by central banks, which buy the metal, not gold equities, while financial demand was falling due to rising real interest rates. Added to this was the fact that with Franco Nevada, the largest of these companies was suffering from a one-off problem in Panama.

Summary

To sum up, stock markets have enjoyed an impressive rally since the end of October last year. This is due to multiple expansion, rather than earnings growth. Many markets have recently been making all-time highs, but year-ahead EPS forecasts remain below all-time highs. The US is the exception, but only thanks to the “Magnificent 6”.

The rise of indexing has clearly changed market dynamics. To a large extent, passive management is momentum-driven, with investors buying the stocks that have risen the most in the belief that they will continue to do so. Financial history shows that when such an approach prevails over a fundamentals-based approach over a long period of time, markets tend to experience major corrections later on.

The risk of a correction is all the greater given that there is a growing divergence between reality and what appears to be priced in. The market rally seems to be based on falling inflation, improving global economic growth, looser central bank monetary policies and accelerating corporate earnings growth. In reality, inflation is no longer falling (at least for the time being) and is even showing signs of rising again, global economic conditions remain weak, expectations of a rapid cut in the Federal Reserve’s key interest rate have been disappointed, long-term interest rates are rising again, and earnings estimates have been revised downwards for most markets and sectors.

Japan and gold remain among our strongest convictions. For both asset classes, however, a correction is not out of the question. Japan is a cyclical market, with the results of the companies making up the main indices strongly linked to global economic conditions. As for the yellow metal, its rise in recent weeks could prompt central banks to slow down their purchases, at a time when rising long-term interest rates are likely to continue to weigh on financial demand.

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