BRUELLAN PANORAMA

Q4/2024

QUARTERLY OUTLOOK / OCTOBER / NOVEMBER / DECEMBER 2024

BRACE FOR IMPACT?

SWITZERLAND

HAS THE TIME FINALLY COME TO INVEST IN SWISS EQUITIES?

EUROPE

AUTUMN HAS COME: WILL THE MARKET MOVE UP AS THE LEAVES FALL TO THE GROUND?

UNITED STATES

"THE TIME HAS COME FOR POLICY TO ADJUST"

ASIA

BIG BAZOOKA NEEDED

Bruellan

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EDITORIAL
BRACE FOR IMPACT?

FLORIAN MARINI, CFA, CMT / CHIEF INVESTMENT OFFICER

In much the same way as Houston's mission control must carefully decelerate a spacecraft to keep it within Earth's orbit without allowing gravity to cause it to crash, the Federal Reserve faces the daunting task of slowing the economy just enough to reduce inflation without triggering a steeper descent into recession. While the economic spacecraft is indeed slowing – and Houston is taking advantage of lower inflation to begin to add velocity, in the form of rate cuts, and thus try to stabilise the orbit – one must ask: is it too late? Should investors brace for impact, with the economy's downward momentum now too strong to reverse?

Base case scenario: a controlled deceleration
Our alternative scenario, which anticipated a second wave of inflation and a bond bear market, has seen its likelihood diminish considerably. The probability of a recession, driven by the delayed effects of past monetary tightening and reduced consumer spending, has increased however, raising the risk of an equity bear market. Still, our base case remains that the economy, like a spacecraft in controlled deceleration, will slow without tipping into recession. Lower inflationary pressures should pave the way for more accommodative monetary policies, which, in turn, would support steady economic growth and solid earnings. Such an environment should continue to constitute a favourable backdrop for riskier assets such as equities.

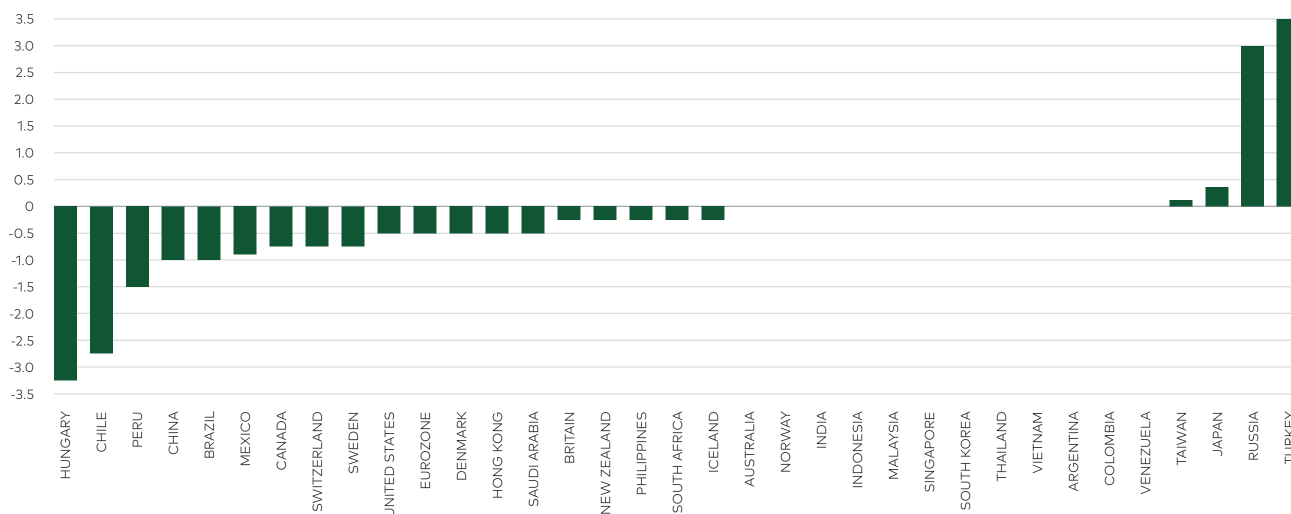
The spacecraft is flying with only one engine
The August market correction was primarily driven by deteriorating macroeconomic data, notably manufacturing activity. The global manufacturing PMI has slipped back into contraction territory at 49.5, after hovering near recession levels for almost two years. Much of this weakness is attributable to sluggish European and Chinese data. Fortunately, the services sector remains strong and is even showing signs of further improvement. The PMI services index has climbed to 53.8, helping keep the composite PMI solidly in expansionary territory at 52.8.

Delving deeper into the figures, only 47% of countries are currently posting an expanding (above 50) manufacturing PMI, up from 38% at the onset of the year. By contrast, a remarkable 100% of countries boast a services PMI in expansionary territory. As a result, global economic growth is being driven primarily by the resilience of the services sector. Put differently, it is "flying with only one engine", which is clearly a source of vulnerability.

Looking ahead to the next few quarters, the pace of activity should decelerate globally but a recession should be avoided. The US should post 1.7% GDP growth in 2025 (down from 2.5%), China 4.5% (down from 4.8%) and the EU 1.6% (down from 1%). China remains a particular concern due to its deteriorating real estate market, weak consumer

Global PMI for Manufacturing and Services (50 Marks the Threshold Between Expansion and Contraction)

Central Bank Policy Rate Changes - Year to Date (YTD)



demand, and money supply contraction. To offset these headwinds and stabilise growth, Chinese authorities will likely need to implement significant stimulus measures.

From a cyclical standpoint, the current economic momentum should thus remain positive through the second or third quarter of 2025.

Central banks could fire the other engine

Progress on the inflation front has been significant, with most countries now near or below the 2% target. The US inflation rate stands at 2.5%, while Germany is at 1.9%, France at 1.8%, Italy at 1.1%, Spain at 2.3%, Switzerland at 1.0%, and China in outright deflation.

As a result, 16 of the world's 35 major central banks – including those of the US, Eurozone, Switzerland, Sweden, Denmark, and Britain – have already shifted to a more accommodative monetary stance this year, a trend that can expected to continue in 2025. Historically, rate cuts by central banks tend to lead improvements in manufacturing PMI levels, suggesting that monetary easing could help reignite growth in the struggling manufacturing sector.

Broadening participation in earnings growth

The Q2 earnings season surpassed already high consensus expectations, with US earnings per share (EPS) growth of 9%. The key takeaway from this reporting season, however, is the broadening participation in earnings growth. Indeed, it marked the first occurrence in 12 months of positive earnings growth (+4.6%) excluding the contribution of the "Magnificent 7" tech giants. In each of the preceding seasons, the S&P 500 had experienced negative earnings growth setting aside the "Magnificent 7".

Looking ahead, Q3 releases are expected to continue this positive trend, as the percentage of companies issuing upward guidance currently stands at its highest level since Q1 2022, while those issuing downward guidance remain below average.

The outlook for the 12-month forward EPS also remains favourable for all the major indices, Stoxx Europe 600, S&P 500, Nikkei 225 and MSCI AC Asia ex-Japan. Valuations appear particularly attractive in Europe and Asia ex-Japan, with forward price-to-earnings (P/E) ratios of 13.6x and 12.3x, respectively. Japanese market valuation is neutral (P/E ratio of 18.7x), while the US market looks more expensive at 21.2x. That said, much of the US overvaluation stems from the "Magnificent 7", with the S&P 500 equal-weighted index trading at a more attractive level of 17x.

A spacecraft in stable orbit

In conclusion, despite a number of headwinds – that include weakening manufacturing data, softening consumer demand, rising deficits, and challenges in China – the overall outlook can still be described as cautiously optimistic. The broad resilience of the services sector continues to provide a solid foundation for economic stability, while the shift towards more accommodative monetary policies, as inflation eases, should help reignite growth in the manufacturing sector during the coming months. Although a slowdown in global growth is to be anticipated, a widespread recession does not lie on the horizon. Furthermore, the broadening of earnings growth and lower interest rates should continue to support our positive outlook for risky assets, such as equities.

The global economy, like a spacecraft in stable orbit, is decelerating under careful control. For now, conditions remain favourable, but Houston (aka the Federal Reserve) faces a delicate task: applying just enough thrust to keep the spacecraft in orbit. In order to avoid both a plunge into recession and an overshooting into the inflationary void of deep space.

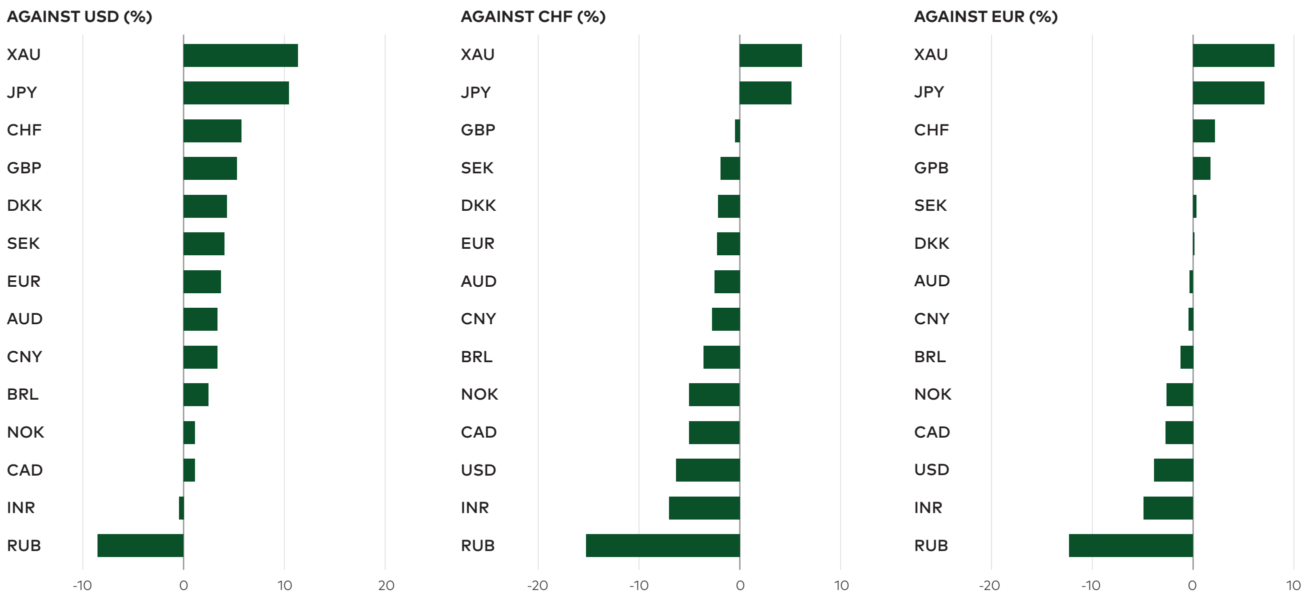
MARKETS PERFORMANCE

Economic Indicators (from 28.06.2024 to 30.09.2024)

	Real GDP %		Inflation %		PMI	Debt % GDP	Current Account % GDP	Budget % GDP	Unemploy-ment %	Interest rates	
	2023	2024	2023	2024	Current	Current	Current	Current	Current	3 months	10 years
USA	2.5	2.6	4.1	2.9	47.0	97.3	-3.2	-5.6	4.0	4.6%	3.7%
Euro Area	0.4	0.7	5.4	2.4	45.0	88.6	2.2	-3.5	6.4	3.0%	2.1%
Switzerland	0.8	1.4	2.1	1.3	49.9	20.9	7.1	0.7	2.4	0.9%	0.4%
UK	0.4	1.1	7.3	2.6	51.5	101.0	-2.2	-4.5	4.3	4.9%	4.0%
Asia ex Japan	4.9	4.6	1.8	1.6	-	4.1	1.2	-5.8	3.7	4.5%	3.5%
Japan	1.8	0.0	3.3	2.5	49.7	216.3	4.4	-5.3	2.6	0.4%	0.9%
Brazil	2.9	2.8	4.6	4.3	50.4	62.0	-1.5	-9.8	6.7	9.6%	12.4%
Russia	3.6	3.4	6.0	7.6	49.5	23.1	3.0	-3.1	2.5	-	-
India	7.0	7.8	6.6	4.8	56.5	46.5	-0.7	-4.4	8.5	7.3%	6.7%
China	5.2	4.8	0.2	0.5	49.3	354.6	1.2	-4.6	4.0	1.7%	2.2%
World	3.2	3.1	6.0	4.6	-	-	0.6	-	7.1	-	-

Market Performance (from 28.06.2024 to 30.09.2024)

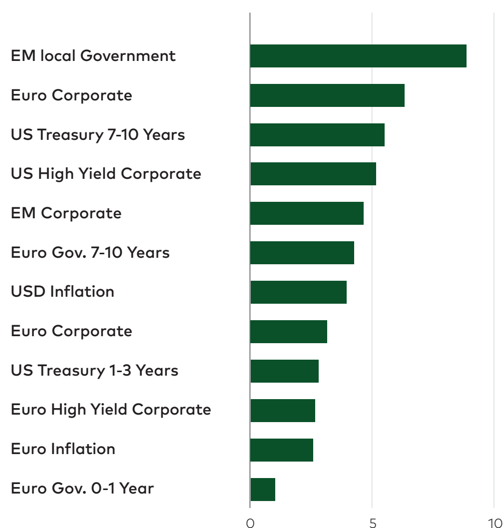
Exchange-Rates



Stock Markets / Total Return & Valuation

	USD	EUR	CHF	GPB	Leading PE	
					LT Median	Current
S&P 500	5.9%	1.8%	-0.5%	-0.1%	17.9	24.2
Eurostoxx	6.5%	2.4%	0.1%	0.5%	14.2	14.4
Swiss Perf. Index	8.6%	4.3%	2.0%	2.4%	19.1	19.6
FTSE 100	7.9%	3.8%	1.5%	1.8%	14.7	12.4
MSCI Asia Ex-Jpn	10.6%	6.3%	3.9%	4.3%	14.7	14.9
Nikkei 225	8.5%	4.3%	1.9%	2.3%	20.5	20.9
Brazil Bovespa	8.9%	4.7%	2.3%	2.7%	14.0	8.9
MSCI Russia	-	-	-	-	6.2	-
India SENSEX	7.3%	3.1%	0.8%	1.2%	20.5	23.9
China CSI 300	21.9%	17.1%	14.5%	14.9%	15.5	14.7
MSCI World	6.4%	2.2%	0.0%	0.3%	17.5	20.9

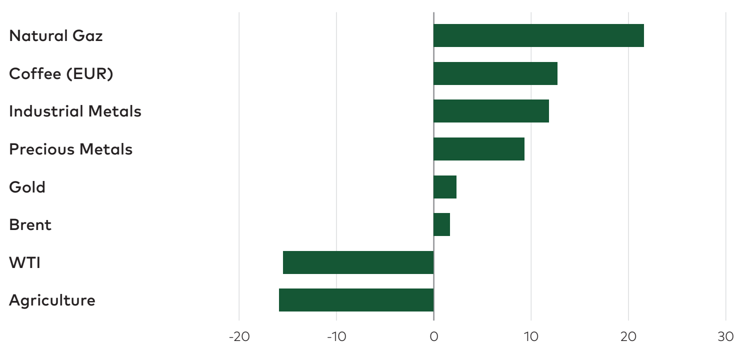
Bond Market



Sectors / Returns & Valuation (Leading PE)

	USA	Europe	World	USA		Europe		World	
				LT Median	Current	LT Median	Current	LT Median	Current
Cons discr.	7.9%	0.7%	7.0%	21.6	28.1	14.7	15.2	18.8	22.2
Cons. Staples	8.1%	5.0%	8.7%	19.4	21.5	18.8	17.0	19.3	20.1
Financials	9.7%	6.5%	10.2%	14.3	16.7	11.8	9.7	13.6	13.8
Energy	-3.1%	-11.3%	-3.2%	14.4	12.9	11.3	7.6	13.5	11.8
Industrials	11.2%	4.7%	10.1%	18.4	25.2	19.0	21.2	18.3	22.5
Technology	1.6%	-10.4%	1.4%	22.2	35.2	25.8	33.2	23.2	34.6
Materials	9.8%	4.7%	9.9%	17.6	23.1	14.7	18.6	16.1	19.6
Utilities	18.4%	12.3%	16.9%	16.8	20.0	13.9	13.2	16.5	16.8
Health Care	5.9%	-1.0%	5.4%	19.5	22.2	20.4	19.5	20.3	21.8
Telecom	1.3%	7.6%	2.6%	17.8	21.1	16.3	15.6	18.3	20.8
Real Estate	16.1%	16.2%	12.3%	43.9	40.7	23.2	16.2	28.3	30.5

Commodities



ALLOCATION GRIDS

Global Asset Classes

	Overweight	Marketweight	Underweight	Main Drivers	Risks
Equities	●			A soft landing, coupled with reduced inflationary pressures, will bring about conditions conducive to more accommodative monetary policies, which in turn should support equity markets.	Miscalculated monetary tightening, that might trigger a severe economic downturn.
Bonds	●			Global bonds offer attractive yields, as inflation drifts lower. Bonds should retrieve their diversification virtues if economic growth drops more than anticipated.	Stickier-than-usual inflation and very expansive fiscal policies.
Gold		●		Receding real rates support gold prices.	Rising real interest rates.
Cash			●		

Equities

	Overweight	Marketweight	Underweight	Main Drivers	Risks
US		●		Solid earnings growth, particularly with participation broadening beyond the tech sector, will be a key support for the US equity market.	Consumer demand that weakens more than anticipated, possibly tiping the economy into recession.
Europe		●		Any confirmation of a US soft landing, supporting global economic growth, would directly benefit the European market. China remains a wild card following the just-announced stimulus package, although we do not expect anything concrete in the short term.	The major risks are both endogenous (recession on either side of the Atlantic) and exogenous, such as political unrest and international conflicts.
Switzerland		●		Six months after its first easing, the SNB's monetary policy could be starting to exert a beneficial effect on manufacturing activity. The manufacturing PMI still stands below 50, but we are seeing a real turnaround.	Swiss franc strength and the mixed trend in the global economy constitute the main risks to our scenario.
Asia Pacific ex-Japan		●		While the Chinese market presents historically attractive valuations, the country's broader economic landscape remains challenging, with sluggish GDP growth, persistent real estate troubles, weak domestic consumption, and deflationary pressures.	Debt and real estate issues, as well as weakening external demand.
Japan		●		Japan is facing inflationary pressures due to rising food and energy costs, while a modest economic recovery is supported by wage growth and domestic demand.	Ongoing inflation, driven by high import costs due to yen weakness, poses a challenge for domestic households and businesses.

Bonds

	Overweight	Marketweight	Underweight	Main Drivers	Risks
Developed Sovereigns	●			Sovereigns are attractive in these early innings of monetary policy easing by central banks. As inflation recedes, they are once again becoming a safe-haven asset,with positive net-of-inflation yields. Inflation-indexed bonds can provide attractive diversification.	Sticky inflation could further slow central bank easing, and expansionary budget deficits could worsen already elevated debt levels and lead to steeper yield curves.
Corporates (IG)	●			High-quality corporates offer a good mix of yields and spreads with a very low default risk; favour medium-term maturities.	A recession, that pressures credit fundamentals and causes financial stress, would widen credit spreads.
High-Yield			●	Caution is warranted, given unappealing spread levels and growing macro uncerta-tintes. Prefer short-dated high yielding bonds.	High-yield bonds could suffer more during periods of financial turmoil.
Emerging		●		Relative valuations are attractive, with also resilient economic and credit fundamentals, against a backdrop of lower developed market bond yields.	Emerging countries could suffer in the case of a global recession, rising USD or significant drop in commodity prices.

Currencies

	Overweight	Marketweight	Underweight	
EUR vs USD		●		The Fed is more accommodative than the ECB, which supports EUR appreciation vs. USD. We remain neutral for now, but would shift to a positive EUR stance if the 1.128 resistance level is broken.
EUR vs CHF			●	Given Switzerland's robust economic fundamentals and safe-haven appeal, the CHF should appreciate against the EUR.
USD vs CHF	●			On a medium-term horizon, the USD should continue to depreciate against the CHF. In the short term, however, it appears oversold and may experience some appreciation. An attractive level to short the USD would be around 0.87.
EUR vs GBP			●	The growing interest rate differential in favour of the GBP should support appreciation against the EUR.
EUR vs JPY			●	Monetary policy divergences among central banks have triggered a significant unwinding of carry trades, which still has room to continue.
USD vs GBP			●	The GBP will likely appreciate vs. USD given the recent shift in interest rate differential, now more favourable for the GBP.

SWITERLAND

HAS THE TIME FINALLY COME TO INVEST IN SWISS EQUITIES?

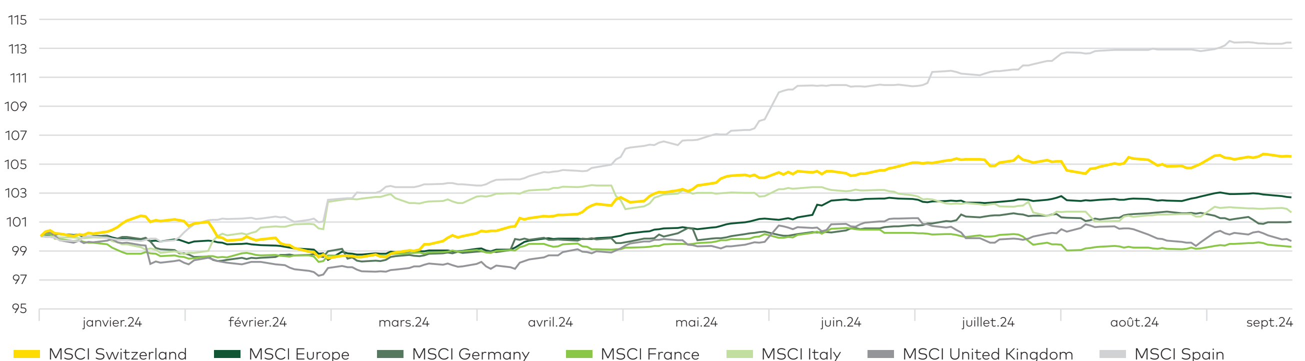
ANICK BAUD / SENIOR FUND MANAGER

More resilient than expected GDP growth and a rebounding manufacturing PMI should not blind us to the fact that the Swiss economy will likely undershoot its long-term potential, in a context of widespread global slowdown. Still, Swiss stocks boast qualities and strengths that could well put them back in the spotlight, amid receding inflation and interest rate cuts.

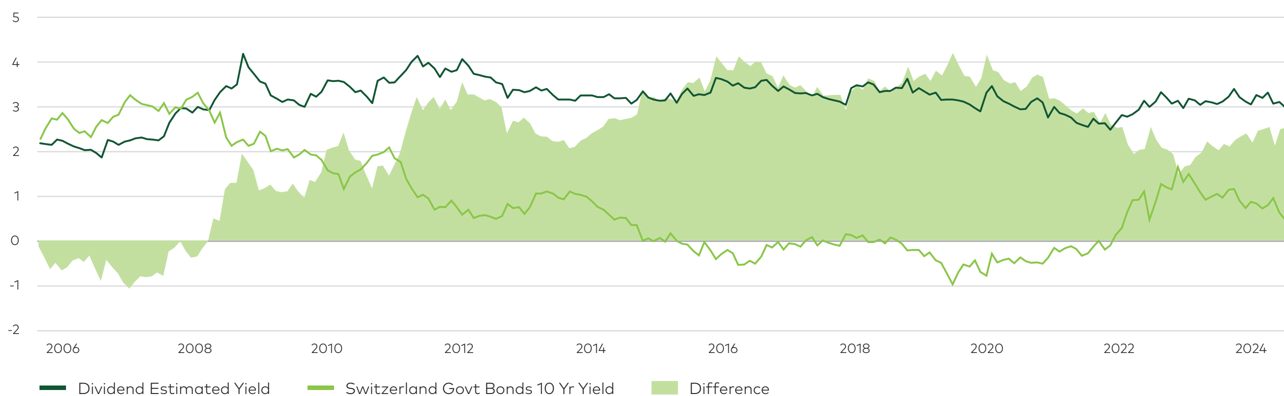
Still below-potential activity:
second quarter Swiss GDP growth (+0.5% quarter-on-quarter, adjusted for sporting events) far exceeded even the most optimistic expectations, despite a rather gloomy situation in many of the country's trading partners. A closer look at this growth reveals that the positive surprise is entirely attributable to the strong rebound in pharmaceutical and chemical exports (+8.4% quarter-on-quarter), which more than offset continued sluggishness in the manufacturing sector. Momentum will likely falter during the final months of the year, and we continue to forecast below-potential growth, at just over 1%. Weakness in Germany and China, alongside Swiss franc appreciation, should continue to hold back activity. And although domestic demand should stay relatively solid, supported by receding inflation and a still buoyant labour market in absolute terms, it could nonetheless come under slight downward pressure. Indeed, the unemployment rate has moved up somewhat recently, from 1.9% to 2.5%, and the extent of short time working at manufacturing companies (now at a level exceeding that of the 2011-2012 eurozone crisis and the 2015 Swiss franc shock) suggests that the labour market could experience a further slight deterioration in the months ahead. That said, a normalisation of activity and a growth rate of ca. 1.5% are expected in 2025, provided international demand does not weaken too much.

Towards a manufacturing turnaround:
the latest figure for the Swiss manufacturing PMI came as something of a surprise to those who closely monitor this data, considered to be a leading indicator of economic health. Although it booked its twentieth consecutive month below the contraction threshold of 50, thereby breaking a longevity record, the improvement relative to the prior month was spectacular (from 43.5 to 49). While the overall figure is undeniably volatile, since based on the change in purchasing manager perceptions from one month to the next, a closer analysis of the underlying data reveals a strong rebound in new orders, with this sub-indicator reaching at a year-to-date high – an encouraging sign. Such dynamism is corroborated by the KOF's monthly survey, in which industrial companies suggest an increasingly confident stance regarding the future development of their business. A quick look in the rear-view mirror reminds us that, historically, accommodative monetary policy tends to precede manufacturing growth by some 6 to 12 months. Since the Swiss National Bank (SNB) began its easing cycle in March, we can hope that the Swiss August PMI is not simply a statistical error, but the first sign of a true turnaround in manufacturing activity. Even so, we should temper our optimism slightly, given that Switzerland's main trading partners, Germany especially, are still posting PMIs that are pointing well south. However, given the easing cycle recently launched by the European Central Bank (ECB), a few months after Switzerland, there is hope that the trend will become more widespread, and a virtuous circle be set into motion.

The Swiss market boasts one of Europe's most dynamic earnings growth



The spread between the average dividend on the Swiss market and the 10-year yield on Swiss government bonds is back to a level that should favour equities



After the fear of inflation, now comes the fear of deflation: since the peak levels that prevailed between August 2022 and March 2023, the level of inflation in Switzerland, measured by both the overall and the core index, has slowed sharply. For over a year now, it has been within the range considered normal by the SNB. The current inflation level (1.1%) is even surprisingly low, which has led to a downward revision of expectations for 2024 and 2025, despite a significant increase in rents. Such faster-than-expected deceleration in inflation is attributable to the strength of the Swiss franc. Its very strong appreciation against virtually all other currencies has made imported goods less expensive, and therefore pushed down the overall price level. According to a UBS study, a 1.5% appreciation of the Swiss currency is sufficient to reduce effective inflation by 20 bp. Given that the franc has appreciated by 2.5% against the euro and 6% against the dollar since June, it is easy to assume that imported goods will continue to weigh on the price index. Could this mean that we are just one step away from deflation? We have not quite reached that point, but excessive pressure on the franc in a context of an overall price slowdown (bearing in mind, for instance, that electricity prices are expected to drop by 10% in 2025) could lead to a disadvantageous situation for Swiss households, who would see their borrowings, mainly mortgage debt, increase in real terms. The other disadvantage of such a scenario is that monetary policy would de facto be overly restrictive in a context of below-potential economic growth. In this respect, the SNB's recent decision to cut interest rates by 25 basis points seems more than judicious. Given the current backdrop, there is an urgent need to relieve some of the unbearable pressure on the national currency, not only for exporters but also for Swiss households. The SNB will also need to implement further rate cuts, with the market expecting another 25 basis points cut in December, before having to draw the ultimate weapon – massive interventions in the foreign exchange market.

Strongly positive momentum for Swiss equities: from 1.5% at the onset of 2023, the 10-year Swiss government bond yield has dropped to barely 0.4% within the space of 18 months, and this downward trend is far from over. The differential between the average Swiss market dividend yield (2.9%) and that of 10-year government bonds has thus returned to levels that once again make a strong case for equities. Moreover, following a period of strong worldwide outperformance by cyclical stocks, the recent weeks have seen defensive stocks regain popularity among investors. In a context of slower growth and falling rates, the search for more defensive stocks should favour the Swiss market, where their weighting far exceeds that of most other markets. Lastly, as we have been pointing out for some months now, a number of factors are at work to support a recovery in Swiss small- and mid-caps, which have been particularly battered during the past two years: the start of a rate cut cycle in the US (with US rates tending to have a greater impact than Swiss rates on this market segment), a historically low valuation level, and a clear improvement in the PMI, an indicator that is strongly correlated with the outperformance of secondary stocks. Were that not sufficient to convince investors, we might add that the Swiss market stands out, with expected 12-month forward earnings per share growth amongst the most dynamic in Europe (MSCI Switzerland +5%), and steadily up since the beginning of the year. Renewed interest in large, defensive stocks, combined with a small- and mid-cap recovery, should enable the Swiss market to regain investor favour after a prolonged period of underperformance.

EUROPE

AUTUMN HAS COME: WILL THE MARKET MOVE UP AS THE LEAVES FALL TO THE GROUND?

MALEK DAHMANI / FUND MANAGER

For more than two decades, the final quarter of the year has generated above-average returns. As we look ahead to intense weeks, amid US elections, geopolitical tensions and alternating expectations of a soft landing and recession, will 2024 prove an exception to the rule?

Autumn has a way of inspiring both melancholic artists, such as Prévert, Camus and Baudelaire, and euphoric market participants, particularly in Europe. While we are reluctant to succumb to market adages and series, that are sometimes far-fetched, it is hard to deny that the statistical facts are tenacious. Over the past ten years, European fourth quarter performance was negative on one only occasion, in 2018. By comparison, over the same period, on average, one in four quarters closed in negative territory. Even more remarkable is the fact that absolute performance is significantly better in the final quarter of the year: since 2014, the European market has gained an average of 2% per quarter, a figure that exceeds 4% when focusing on the end of the year.

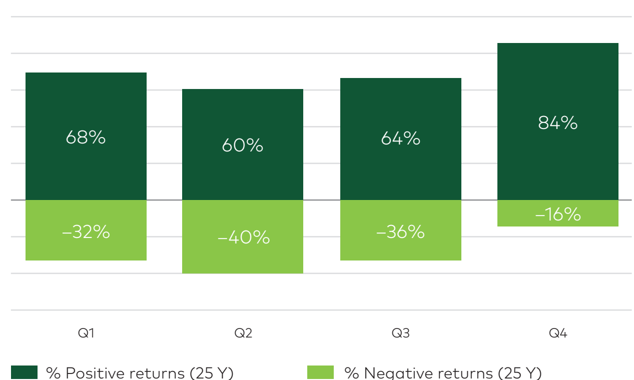
This trend is also confirmed over a 25-year history, with the fourth quarter boasting a positive performance in 84% of cases, vs. just 64% for the other quarters of the year. Is it a matter of renewed optimism after the holidays or serenity brought about by the Indian summer? Numerous academic studies have investigated the seasonal nature of markets, without coming up with convincing answers. Therefore, while it may be tempting to rely solely on traditional patterns, we will make sure to support our year-end outlook with thorough analysis. After all, it's well known that "every series must eventually come to an end"!

So, as Europe steps into the final quarter of 2024, our question is the same as elsewhere on the globe: will the US pull off a soft landing, or will they fall into recession? For several quarters now, European companies have depended mainly on US growth, the other pre-COVID economic engine, aka China, having come to a complete standstill. As for the domestic European market, while certainly not as disastrous as some may suggest, thanks notably to the resilience of the services sector, it is still not sufficient to carry economic growth.

Expectations of a US recession intensified during the summer, on the back of weaker-than-expected employment numbers. This concern accelerated the sector rotation that had begun in the second quarter. Although the Stoxx 600 index gained 1% over the summer, cyclical stocks lost significant ground vs. defensive stocks. The performance differential between these two segments exceeded 8% for the period. The semiconductor and luxury goods sectors, market leaders at the onset of the year, shed much of their gains to sectors that are more resilient to the economic cycle, such as utilities and telecoms. The last two weeks of the quarter saw a rebalancing in favor of cyclical stocks, driven in particular by better macroeconomic news from the United States and stimulus announcements from the Chinese government.

Q4 boasts outsized returns over the past 10 and 25 years

The occurrence of positive returns during the fourth quarter is far superior to that of the other quarters.



An increase in the money supply generally leads to an improvement in the manufacturing PMI.

As indicated in our global strategy (see editorial), a soft landing is our central scenario, with the economic cycle continuing at a moderate pace, and no recession. Being the region most sensitive to global growth, Europe would automatically benefit. Lower interest rates, notably on the part of the ECB, coupled with more accommodative money supply should improve investment conditions, a crucial factor in the recovery of the European manufacturing sector.

Against this backdrop, how should investment portfolios be positioned? At first sight, it might be tempting to favour cyclical stocks, following their recent underperformance. Their reaction to the 50-basis point rate cut announced by the Fed shows their potential for rebound, should a soft-landing trajectory be confirmed. That said, we consider it wiser to maintain a portfolio of high-quality cyclical stocks, that are underpinned by long-term trends, while combining them with defensive stocks, inversely correlated with interest rates. This strategy can help navigate the latter part of the economic cycle more effectively, while providing some protection in case of any missteps in central bank policy easing.

Moreover, we are convinced that some exogenous factors will bring about greater volatility. Firstly, the US elections could cause turbulences, both because of opportunistic geopolitical strategies (conflicts in the Middle East and Ukraine) and because of possible social tensions before or after the results. A sector rotation could take place, working in particular against companies that export to the US, if Donald Trump were to move into the White House. We thus favour companies that have already set up local production, reducing their exposure to this risk.

A word, finally, regarding the economic stimulus measures recently announced by the Chinese authorities. In this respect, it is important to note that the current economic slump in China is weighing on the European manufacturing sector, particularly in Germany, and that few of the continent's investors or company managements are anticipating a rebound in activity during the next few quarters. In this sense, any economic surprise coming out of China – probably more likely in 2025 – would provide a tremendous boost, well received by the markets.

In conclusion, given the generally favourable winds in the final quarter of a year, with investors on the lookout for any piece of good news, the slightest figure that confirms the hypothesis of a US soft landing will support the European market. Still, we should not ignore the fact that the few negative fourth quarter performances of the past two decades were generally very significant – with a 22% drop in 2008 and an 11% drop in 2018. The autumn quarter is definitely like no other...

UNITED STATES
"TS TIME HAS COME FOR POLICY TO ADJUST"
FEDERAL RESERVE CHAIR JEROME POWELL

FLORIAN MARINI, CFA, CMT / CHIEF INVESTMENT OFFICER

As we close the third quarter, the rhetoric surrounding a potential recession is once again dominating market discussions, fuelled by concerns about weakening consumption and a Fed that has fallen behind the curve. While signs of slower growth are evident following the Fed's aggressive tightening cycle, the critical question remains: is the US headed for recession, or is a soft landing still achievable? Should a recession indeed materialise, mere rate cuts may not be enough to stave off a bear market. In a soft landing scenario, however, a cycle of rate cuts could serve as a tailwind for risky assets, supporting further equity market gains.

Cooling growth with inflation under control

The US economy is currently experiencing a notable deceleration. After averaging a strong 3% over the past four quarters, real GDP growth is projected to slow to 2.3% and 1.8%, respectively, in the third and fourth quarters of 2024. This trend should then continue moving into the new year, with similar growth rates anticipated for the first two quarters of 2025 (1.9% and 1.7%). In annual terms, while 2023 posted solid growth of 2.5%, and such momentum is expected to endure in 2024, a deceleration to 1.7% or less will likely occur in 2025.

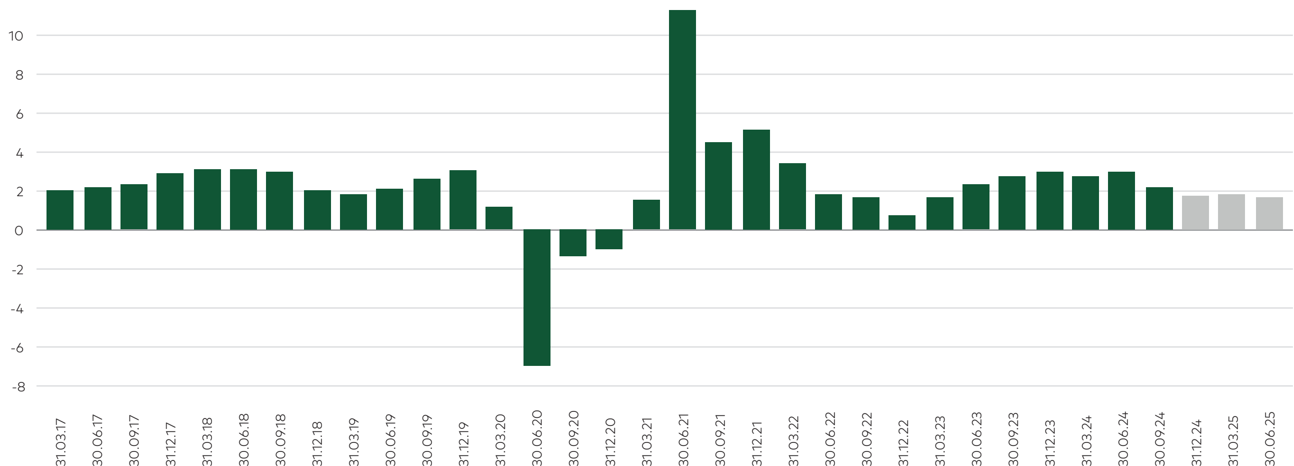
The composite PMI, a key leading indicator, currently stands at a year-to-date high, suggesting firm growth ahead. That said, its breakdown provides a more mixed message. The services PMI remains comfortably in expansion territory and has strengthened throughout the year. The manufacturing PMI has, however, fallen back into contraction territory and is showing few signs of an immediate recovery. Notwithstanding this divergence, the overall economic cycle appears stable and, based on historical patterns, momentum should remain positive through mid-2025. For now, there are no strong indicators of an impending recession.

On the inflation front, meanwhile, the picture continues to improve. Core inflation, though sticky due to persistent wage and shelter inflation, is expected to decelerate in the coming quarters (chart 2). Energy inflation, despite OPEC+ production cuts and geopolitical tensions, is not a major concern, with crude oil prices declining and gasoline prices returning to pre-pandemic levels.

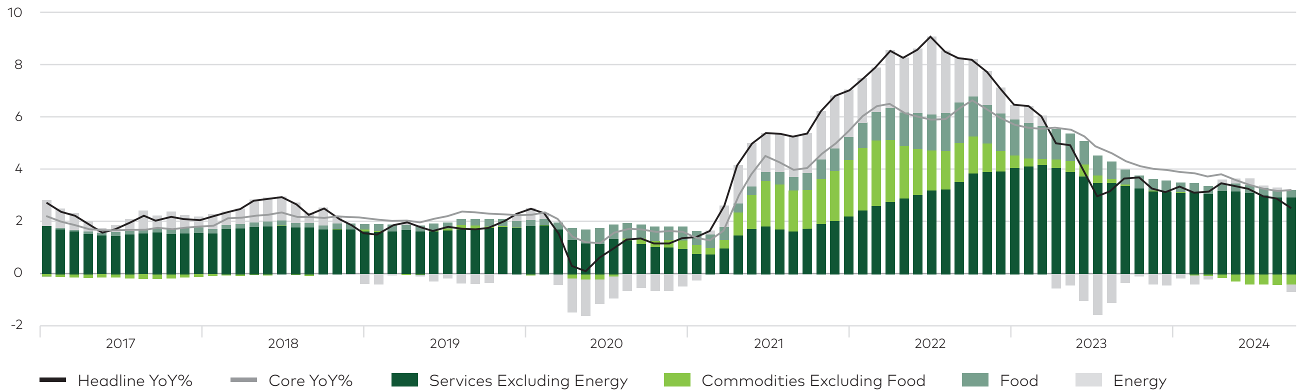
Labour market adjustments: a necessary step to control inflation

The recent softening in the labour market is a necessary step to help bring down inflation, as there is typically an inverse relationship between unemployment and inflation

Economic deceleration but no recession – quarterly GDP growth (YoY%)



Inflation should continue to decelerate – persistent services inflation to date (dark green) likely to contribute to a decline in headline inflation



(commonly known as the Phillips Curve). The Fed has taken actions to cool the economy, resulting in weaker labour conditions, as part of its efforts to reduce inflationary pressures. Although jobless claims indicate some softening, we do not expect this to trigger a negative feedback loop whereby rising unemployment weighs significantly on consumer spending, causing further job losses and, ultimately, a recession. Low-income households obviously face challenges, but the broader consumer base remains relatively resilient, supported by lower debt levels and significant assets compared to historical pre-recession periods.

With its recent 50 basis point rate cut in September, the Fed has clearly shifted towards a more accommodative monetary policy. US inflation, now at around 2.5%, continues to decelerate, while labour market conditions are softening. This makes Fed policy easing possible, with the objective of reducing recession risks all the while keeping inflation under control. The Fed is expected to implement another 50 basis points of rate cuts by year-end, with further reductions of more than 100 basis points in 2025.

Broader participation in EPS growth

The second quarter earnings season surpassed expectations, with S&P 500 quarterly EPS growth of 9%. Of particular note are the shifting dynamics of this growth. Since the third quarter of 2023, S&P 500 earnings had been heavily reliant on the "Magnificent 7" technology stocks. Without their contribution, a contraction in earnings would have been experienced. This changed during the latest reporting season, with ca. half of earnings growth coming from the broader S&P 500 components, excluding the "Magnificent 7". Such reduced dependence on the information technology sector signals a healthier broadening of participation across industries, a positive development for the overall market.

Conclusion

We expect the US economy to shift from a period of robust growth to one of measured deceleration. With inflation easing and the labour market adjusting, the Fed will likely continue to adopt a more accommodative monetary policy, potentially providing a cushion against downside risks. The central question remains whether the Fed will be able to achieve a soft landing, which is our base-case scenario. Solid earnings growth, particularly with broadening (non-technology) participation, will be a key support for equity markets, contributing to a positive backdrop for them and other risky assets.

That said, we continue to watch out for alternative scenarios, particularly one in which consumption weakens more than expected, which could tip the economy into recession. While this is not our primary expectation, it does represent a meaningful risk that we intend to monitor closely during the coming months.

ASIA

BIG BAZOOKA NEEDED

FLORIAN MARINI, CFA, CMT / CHIEF INVESTMENT OFFICER

As the Chinese economy navigates a period of significant challenges, investors are confronted with a complex landscape of slowing GDP growth, a troubled real estate sector, and weak domestic consumption. Despite historically attractive equity valuations, uncertainty prevails due to ongoing deflationary pressures and the lack of clear growth catalysts.

Economic overview

China's GDP growth slowed to 4.7% year-on-year in the second quarter, below the government's 5.5% target. Projections for the last two quarters of 2024 suggest a similar pace of growth, likely leading to a full-year rate of ca. 4.8% or less, with a further deceleration to 4.5% expected in 2025. Leading indicators such as the manufacturing PMI, as well as its new orders subcomponent, provide little hope for a rebound, fluctuating between expansion and contraction. While the services sector remains a bright spot, other parts of the economy continue to struggle.

The credit impulse and M1 monetary aggregate are two crucial indicators of future activity and, currently, both signalling caution. The credit impulse, which measures the change in the flow of new credit as a percentage of GDP, remains sluggish, with negative readings. M1, which reflects the most liquid forms of money in the economy, has now also entered negative territory. Its decline indicates reduced liquidity and confidence among businesses and consumers, further reinforcing the subdued outlook for Chinese economic activity.

A troubled real estate market

The ongoing economic slowdown is largely driven by persistent turmoil in the real estate sector, which shows no signs of improvement or stabilisation. Since our last strategy update, commercial residential prices have continued to decline, with the 5% year-on-year drop in July marking the 28th consecutive month of contraction. Despite significantly lower mortgage rates – down from 5.5% to 3.45% – there has been no discernible improvement in market conditions.

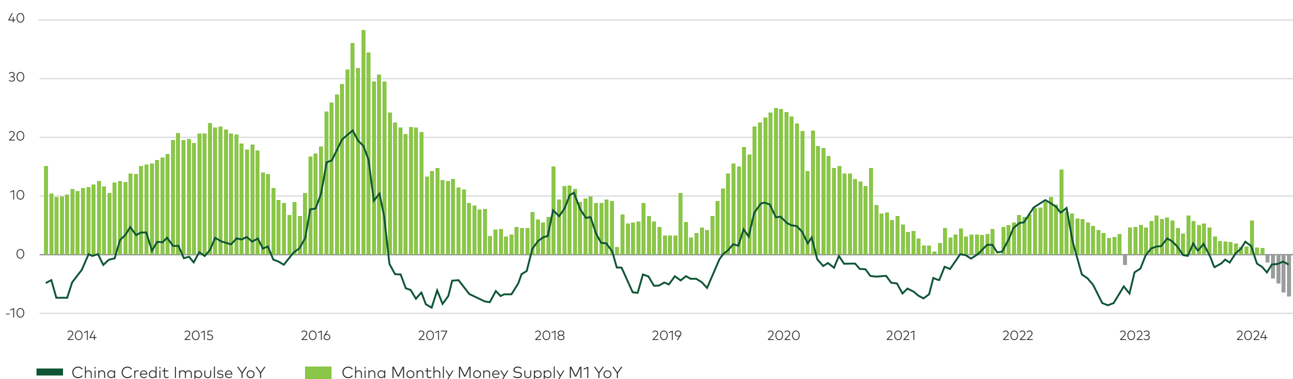
Government efforts to stabilise the sector, including easing purchase restrictions and reducing mortgage down payment requirements, have yet to restore confidence among buyers and investors. Authorities are now reportedly working on plans to decrease the oversupply in the market. Analysts predict that a full recovery of the real estate sector could take four to six years, due to excess supply and a slow rebound in demand.

Weak domestic consumption

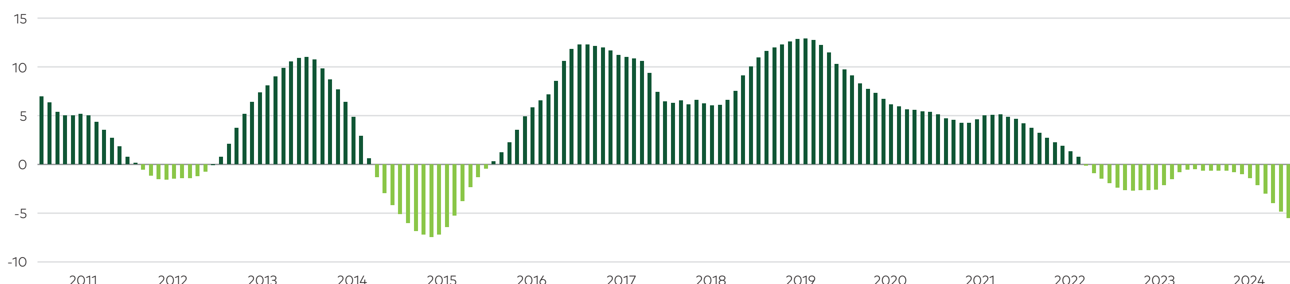
Despite government efforts to boost consumer spending, household consumption remains weak. This sluggishness is attributable to several factors, including the lingering effects of the pandemic, a high level of household savings, the aforementioned deteriorating real estate market, and a cautious consumer mindset, with many expressing a lack of trust in the government's ability to manage economic challenges.

Retail sales have grown at an average year-on-year rate of just 2.7% since the beginning of 2024, significantly below the pre-COVID monthly average of ca. 8%. While online retail sales have performed better, with an average year-on-year growth rate of 9.5%, this too remains below pre-pandemic levels.

Chinese credit impulse and M1 monetary aggregate: indicators of subdued economic activity



Prices of newly built commercial residential buildings in China (YoY)



An export recovery

Exports, a key driver of the Chinese economy, have weakened since the final quarter of 2022 due to declining global demand, especially from the US and the EU. While the last three months have seen some recovery, with export growth exceeding 7% year-on-year, global economic uncertainty, fuelled by geopolitical tensions and inflation, continues to weigh on Chinese exports.

The recent 100% tariff imposed by Canada on Chinese-made electric vehicles underscores ongoing trade challenges. Tensions with the US could escalate, particularly if Donald Trump moves back into the White House, with proposed tariffs that could cut Chinese GDP growth by up to two percentage points. It should nonetheless be pointed out that, despite past US tariffs on USD 300 billion of Chinese goods, exports from China to the US have remained strong, highlighting their competitiveness and the widening US trade deficit.

Inflation and currency dynamics

China's sluggish growth and weak demand are reflected in low inflation, with consumer prices up only 0.5% year-on-year, close to deflationary territory and well below the 20-year median of 2%. The producer price index (PPI) has been deflationary since the final quarter of 2022, indicating weak industrial demand.

The renminbi (RMB) has depreciated due to the interest rate differential vs. the USD, though recent Fed actions have bought about a stabilisation. Still, the Chinese currency remains vulnerable to global market fluctuations and ongoing economic uncertainties.

Attractive valuation but still a lack of catalysts

With a P/E ratio of 11x for the Shanghai Shenzhen 300 Index and 8.3x for the Hang Seng Index, the Chinese market is currently trading at very attractive levels in historical terms, hovering near cyclical lows. It is, however, crucial to recognise that the region still lacks clear catalysts or sufficient improvement in economic fundamentals to justify an extensive investment.

Investment strategy implications

In conclusion, while the Chinese market presents historically attractive valuations, the country's broader economic environment remains fraught with challenges. These include sluggish GDP growth, ongoing real estate sector instability, weak domestic consumption, and persistent deflationary pressures. Although there are early signs of a recovery in exports and the services sector, the absence of clear catalysts or a meaningful economic stabilisation argues for a still cautious investment stance.

The comprehensive stimulus package announced by Chinese authorities on September 24 and 26, aimed at alleviating property market distress, enhancing liquidity, and strengthening fiscal support, represents the most significant monetary and fiscal intervention since the pandemic. While this initiative marks a positive shift in policy direction and will likely help China meet its GDP growth target, as well as bolster market sentiment, it is unlikely to fully restore consumer and corporate confidence in the short term.

Until more concrete signs of recovery emerge, or stronger, policy-driven growth catalysts materialise, investors are advised to remain selective and maintain a defensive approach. While the CSI 300 Index lacks appeal in the current environment, the Hang Seng Index has shown notable EPS growth improvement, potentially offering selective opportunities for discerning investors.

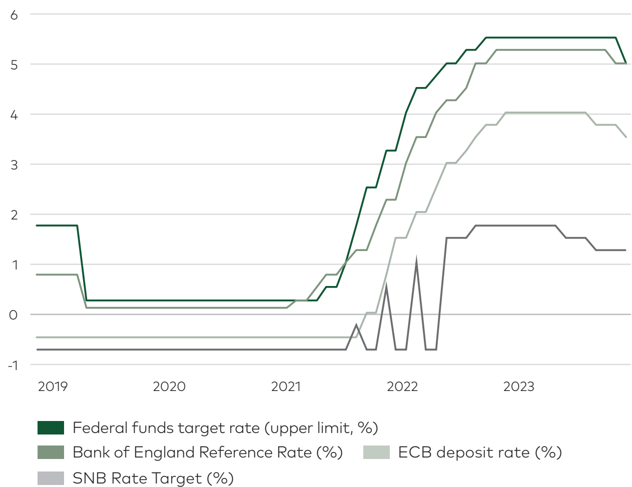
FIXED INCOME

MANUEL STREIFF / ADVISOR

The Fed, aligning with other major central banks, initiated its rate-cutting cycle with a decisive 50-basis-point reduction. In an environment of subdued inflation, signs of labour market weakness prompted this policy shift. While the US economy remains balanced, the Fed's updated projections, as depicted by its «dot plot,» signal additional rate cuts at each upcoming meeting through the next quarter. Market participants have already priced in a reduction to ca. 3%, though we foresee potential for further cuts as inflation trends toward the Fed's 2% target.

Yield to maturity per fixed income segments: Sovereigns, Corporates, Emerging debt in local currencies, Emerging debt in USD and High Yield

Key central banks target rates

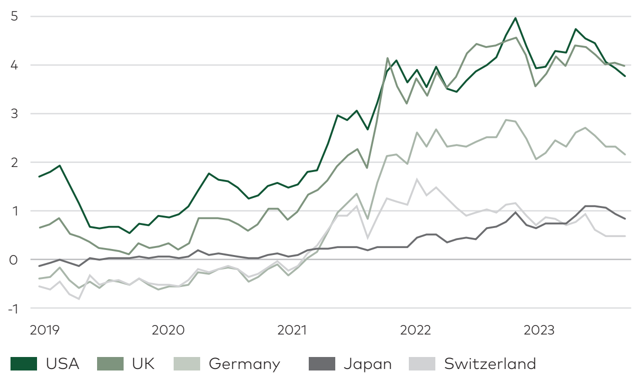


DEVELOPED MARKET SOVEREIGNS

Aggressive, front-loaded central bank actions have compressed front-end yields, steepening yield curves and driving renewed interest in developed market bonds.

Thus far, the US has led the global easing cycle, with a sharp deceleration in inflation and labour market rebalancing pushing US yields lower than their European peers. Although the ECB has begun to cut rates, its policy actions have been more constrained due to persistent wage inflation pressures. In France, political uncertainty has maintained wider-than-usual spreads relative to Germany, while Italian-German bond spreads have traded within a tight range. Swiss bonds have demonstrated stability, with short maturity yields declining, reflecting expectations of further monetary easing in response to the strong franc.

Sovereign yield to maturity (10Y benchmarks)



Our outlook remains constructive on mid-maturity sovereigns. These securities tend to exhibit the greatest sensitivity to further yield declines, which will likely be most pronounced at the front end of the curve.

DEVELOPED MARKET CORPORATES

The government bond rally has been a key driver of performance for investment-grade corporates. High-yield bonds have also experienced strong demand as investors increasingly price in a soft-landing scenario. While recession risks have not disappeared entirely, the ongoing disinflation trend has given central banks the flexibility to maintain accommodative policies, which continues to support credit markets.

Despite ongoing geopolitical headlines, credit markets remain largely unfazed, with fundamentals taking precedence. Short-term, high-yielding debt from issuers with solid financing profiles remains attractive, particularly at the front end of the curve, where total yields are still compelling, even with tighter spreads.

HARD CURRENCY EMERGING MARKET DEBT

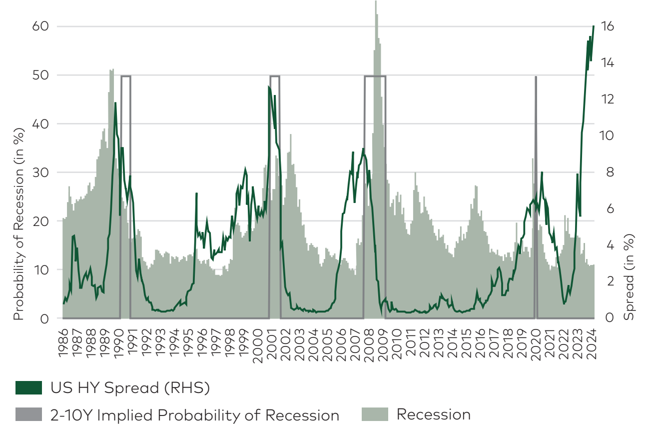
Emerging market (EM) hard currency sovereigns have outperformed, bolstered by their longer duration amid a period of rapid yield declines.

As central banks worldwide initiate monetary easing cycles, EM hard currency bonds are poised to benefit further from enhanced global liquidity.

In the EM US dollar-denominated corporate bond space, relatively high yields have prompted a notable shift, encouraging issuers to pivot towards local currency bonds. This trend is expected to persist, gradually reducing supply in US dollar issuance.

US and European Corporate Spreads (Investment Grade)

US High Yield spreads and probability of recession, as derived from the yield curve



Emerging Spreads (corporate and sovereign) and emerging currencies index (vs. USD, inverted)

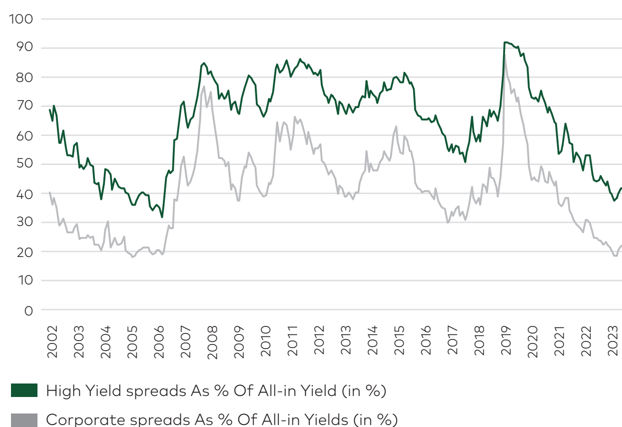
LOCAL CURRENCY EMERGING MARKET DEBT

Local currency EM bonds staged an impressive rally, largely driven by lower yields in developed markets and a weakening greenback. EM central banks, with greater flexibility to ease monetary policy, have taken advantage of this backdrop across most regions.

While performance has been strong across the board, Latin American local bonds have stood out, even in the face of a rate hike in Brazil.

The ongoing US dollar depreciation, coupled with declining global yields, reinforces our positive outlook on EM local bond markets. That said, we remain mindful of potential risks, including the possibility of a shift towards more protectionist US trade policies in the event of a change in political leadership.

Credit Spreads as % of all-in Yields



FIXED INCOME PROJECTION

Segments	Yeld (%)			Return View (12m horizon)
	USD	EUR	CHF	
Cash	4,78	3,03	0,79	↘
Short-Term High-Yielding	5,42	3,80	1,05	↗
10y Government Bonds	3,78	2,09	0,43	↗
10y Government Inflation-Linkers	1,57	0,21	n.a.	↗

Segments	Spread over Sovereigns (bps)	Return View (12m horizon)
Developed Corporates	99	↗
Corporate Hybrids	195	↗
Developed High Yield	367	→
Emerging Sovereigns	299	→
Emerging Corporates	219	→
Emerging Local-Currency Debt	n.s.	↗

Source: Bloomberg indices hedged in the respective currency

CREDITS
CONTRIBUTORS

REDACTION
Florian Marini, Chief Investment Officer
Anick Baud, Senior Fund Manager
Malek Dahmani, Fund Manager
Manuel Streiff, Advisor

GRAPHIC DESIGN
Yves Ninghetto, LaFabrique Geneva

PROOF READING
Karen Guinand

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CONTACTS

WHERE TO FIND US

GENEVA

Bruellan S.A.
Rue Pecolat 1
CH-1201 Genève

Tél +41 22 817 18 55
www.bruellan.ch

VERBIER

Bruellan S.A.
Rue de Médran 16
CH-1936 Verbier

Tél +41 27 775 56 56
www.bruellan.ch

CRANS-MONTANA

Bruellan S.A.
Rue du Pas-de-l'Ours 6
CH-3963 Crans VS

Tél +41 27 486 24 24
www.bruellan.ch

www.bruellan.ch

GSTAAD

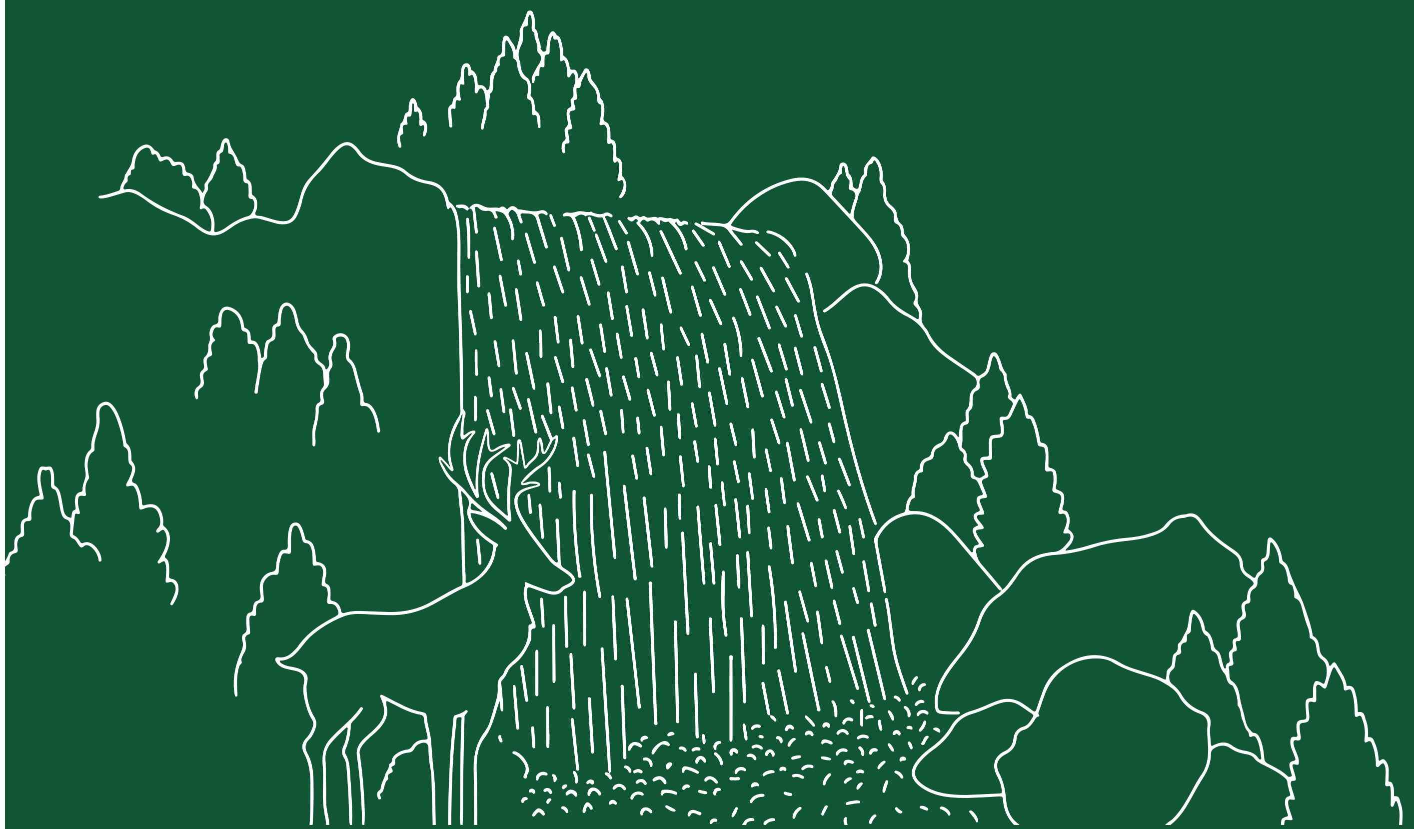
Bruellan S.A.
Gstaadstrasse 8
CH-3792 Saanen

www.bruellan.ch

MARTIGNY

Bruellan S.A.
7, Place du Bourg
CH-1920 Martigny

www.bruellan.ch



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