BELVÉDÈRE
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H4L

# MARKET INSIGHTS

# H4L

A new acronym is taking hold around financial markets: H4L – higher for longer. This means that interest rates, notably the central banks' prime rates, will remain at today's high levels longer than many market players had expected or hoped. As a reminder: As recently as in May, markets had assumed that the US Federal Reserve (Fed) would not only refrain from raising its key interest rates further, but actually cut them four times by the beginning of 2024. Even at that time, this assumption seemed grossly hyperbolical and was hovering over the markets rather like a sword of Damocles in case the rate cut fantasies were to be priced out one day and a key driver of the stock market boom were to thus vanish into thin air.

Most remarkable about it was the fact that the expectation of US interest rate cuts was then corrected significantly and this had no noticeable impact on markets. Now, with some delay and some proficient "verbal support" from central banks, H4L has hit the markets and left its mark in the third quarter. Interest rates for 10-year government bonds rose significantly from June to September. In the US, for example, from 3.84% to 4.57% (the highest level since 2007) or in Germany from 2.39% to 2.84%, causing bond investors losses of more than 3%. Investors in Swiss federal bonds were but slightly better off. The rise in interest rates in the third quarter from 0.96% to 1.10% resulted in a price drop of around 2%. The interest rate movement was also the main reason for the setback in equity markets. From the annual or interim high – depending on the market – at the end of July, the SPI fell by 3.7%, the EuroStoxx by 6.1%, the S&P 500 by 6.3% and the Chinese CSI300 by a whopping nigh-8% (in the respective local currency).

Three questions come up for the remainder of the year. First: Was that it for interest rate hikes? Answer: Yes. Central banks may have left the option open for further interest rate hikes. Given the persistently weak growth and the sticky albeit receding trend in inflation, they will hold back with any further interest rate steps. As for long-term interest rates, this also means that with the latest hikes, rates are close to a peak. Second: Will the economic downturn lead to a recession after all? Answer: Not in the US, whose economy is still doing surprisingly well. Probably yes, anyway "technically", in the more cyclical euro zone. And uncertain in China, where much depends on how the real estate sector evolves and on the government's willingness and ability to offer support. And third, what does this mean for equity markets? Answer: Higher interest rates and weak growth have probably been priced in already to a large extent. Consequently, H4L is losing some of its fright and a sustained bear market is not to be expected. However, H4L does stand in the way of a palpable recovery. Triggers for a significant rise in stock prices are missing. "Sideway volatility" – a buzzword I am actually loathe to use – seems a realistic scenario for this year's final quarter. And there remains hope for a year-end rally, which is so often witnessed.

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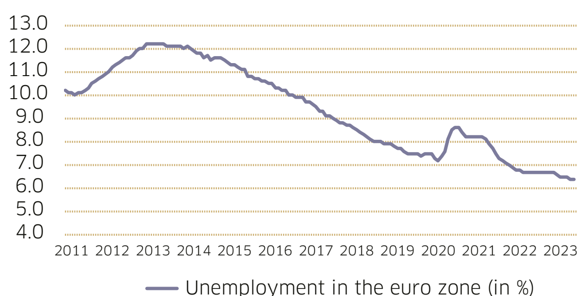
## ECONOMY

The US economy carried the momentum from the second quarter into the third, fuelled by solid private consumption, business investment and a recovery in manufacturing, where destocking seems to be over. Higher interest rates have had hardly any negative effects so far – only residential construction is in a decline. Things look different in the euro zone, though: after GDP growth already came to a grinding halt in the second quarter, the data deteriorated further over the next quarter. Persistently high price levels are putting pressure on consumption and orders for the manufacturing industry are dwindling. One of the few bright spots remains the labour market (see chart). China started off with a continued downturn in the real estate market. The government's attempt to intervene with a range of minor measures slowed the downturn towards the end of the quarter. Consumption, industry and exports also improved.

Outlook: Determining factors include higher oil price, pandemic savings running out and higher interest rates. The US economy might be the best in handling these challenges, but will not be able to avoid a slowdown. In the euro zone, risks are rising and stagnation is likely. China has a chance of further improvement. However, the situation remains fragile, as evidenced by the resurgent issues at the real estate companies Evergrande and Country Garden.

**Unemployment on the decline**



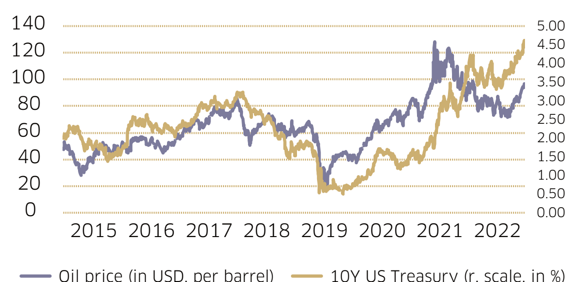

Source: Bloomberg, BAM

## INTEREST RATES

The past quarter saw some massive movements in the fixed-income market. Interest rate hikes were the steepest in the US, where 10-year Treasury bond yields hit 4.6%, the highest level since 2007. This was primarily owed to the strong economic environment described above, which fuelled fears that the Fed could keep interest rates high for longer. A rating downgrade by Fitch and quantitative tightening (QT) reinforced the trend. The trend was less pronounced in the euro zone, but interest rates rose there as well. In Switzerland, on the other hand, the increase was just marginal. Inflation having already fallen below 2%, the Swiss National Bank passed up on raising rates further at its last meeting. The Bank of Japan loosened interest rate controls, which led to a rise in 10-year rates to 0.74%.

Outlook: The expected economic slowdown combined with a decline in inflation and the fact that central banks have most likely completed their rate hike campaign all point toward lower interest rates. High borrowing and QT suggest further rate hikes. The bottom line is that the potential for further increases is limited, but a rapid decline is just as unlikely.

**Bond yields keeping pace with oil price**




Source: Bloomberg, BAM

## EQUITIES

After two positive quarters, equities suffered a setback in the third quarter. The S&P 500 lost 3.3%, the Euro Stoxx 4.1% and the SPI 3.3%. Swiss small and mid caps corrected at an above-average rate of 5.7%. This was mostly due to the massive rise in interest rates at the long end. In addition, the economic issues in China clouded the mood. Luxury goods stocks such as Richemont (–23.9%) and Louis Vuitton (–17%) were particularly affected. On the other hand, energy stocks such as Eni (+17.6%) and Exxon Mobil (+10.6%) benefited from the higher oil price (+26.8%).

We hold on to our view that opportunities and risks are roughly balanced. Companies are generally well positioned, benefiting from higher prices and efficiency measures. Earnings estimates are rising accordingly. There is also a chance that the destocking may be over and the economy in China is stabilising. This would particularly benefit companies in Switzerland and the euro zone. The biggest risks are an economic slowdown in Europe and the oil price rising well above USD 100. However, we believe this risk is limited, as demand would decline at such high prices.

| Asset class | Appraisal | Commentary |
|---|---|---|
| **Bonds** | | Interest rates have put a large part of the upward movement behind them. However, it may be premature to hope for a rapid decline in interest rates, also because central banks will tend to keep rates high for a while longer. |
| Government bonds | | |
| Corporate bonds | | |
| **Equities** | | Equities ended the third quarter with losses in the mid-single digits. Equity markets are likely to remain volatile in the fourth quarter. We focus on high-quality stocks with little debt. |
| Switzerland | | |
| Euro zone | | |
| United Kingdom | | |
| US | | |
| Emerging markets | | |
| **Real Estate** | | In the third quarter, real estate asset prices remained virtually unchanged on balance, fundamental demand is still intact and valuations are interesting. However, higher interest rates could have a dampening effect. |
| Switzerland | | |
| **Commodities** | | Following a strong rise, the air is getting thin for the price of oil. We see still no incentive for gold. |
| Oil | | |
| Gold | | |

unattractive — attractive | Current asset class assessment

Imprint
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