MARKET COMMENTARY

Growth fears trigger another painful summer market drawdown.

Joint piece from GenAM Macro & Markets Research and Liability-Driven Investment Team

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- **Souring manufacturing sentiment and worse than expected employment data have raised fears of the Fed falling behind the curve in providing accommodation to an economy running out of steam. Moreover, disappointing sentiment data (e.g. PMIs) and further evidence of a struggling German economy raised concerns about the sustainability of the EA recovery.**
- **The weakening in activity and the labour market is undeniable and the odds of a mild recession in early 2025 have risen to around 1/3, but looking beyond payroll data, we do not see large scale job destruction in the short term, as the drivers of domestic demand (chiefly disposable income) are not tanking. Indeed the non-manufacturing ISM today came out slightly above expectations, signalling ongoing expansion.**
- **The Fed will emphasise its easing bias more strongly, helped by benign inflation prints. Another batch of poor activity data over the summer will very likely lead to three 25bp cuts this year (vs. between 100 and 125bp of cuts currently priced by the market, including 50bp by the Sep. meeting). The repricing of the ECB rate policy looks slightly excessive: we stick to our year-end 2025 expectation at 2.5% (vs. market priced near 2%, from currently 3.75%).**
- **In recent days, core yields have accelerated the downward trend that began in July. Further declines cannot be ruled out in the short term, but along with central bank pricing, the move looks slightly stretched. Still, we would gradually buy the deep in Euro rates if the rally reverses.**
- **In credit markets, the recent concerns about the strength of the US economy haven't really translated into massive HY/IG as well as Fins/Non-fins decompression so far, which is somewhat surprising. Indeed, demand remains resilient, driven by the still elevated all-in yield, absence of supply over summer months and the low share of tech in credit indices, especially in Europe. CDS, more correlated to equities, have under-performed cash. If fears of US recession are confirmed spreads will have to reprice further but for the time being, we remain relatively constructive given our expectations of 1/ peaking defaults 2/ strong technical and 3/ attractive carry versus government bonds. Still, credit spreads will look relatively expensive if macro evidences on a deep deterioration accumulate. Position for decompression (preference for safer segments).**
- **A perfect storm of a BoJ rate hike and FX intervention, higher risk aversion and lower US yields have pushed the JPY sharply up pushing the TOPIX into descent and contributing to the global risk-off sentiment.**
- **Equity markets carried some risks before the current slump, namely high positioning, negative macro surprises and elevated US valuation. US soft landing uncertainties and raising doubts about AI returns on huge capex expenditures have added to disappointing consumer-related firms' results and a spike in the yen. From peak, the Topix is down 20%, EM 6%, S&P 500 9%, Nasdaq 17%, Stoxx 50 nearly 13%, while EU cyclicals are down 7% vs. Defensive.**

- **Short term, markets remain at risk, as elevated risk-on positions may need more time to reverse. Increased volatility also represents headwinds to firms' confidence. For now, it looks worth maintaining a tilt towards defensive sectors versus cyclical ones.**
- **On the positive side, the Q2 reporting season, after nearly 380 US firms reported, shows a 5% positive earnings surprise, similarly to Europe (300 have reported). Furthermore, US unit labour costs look supportive for firms' margins and US GDP numbers are not falling over the cliff (Q2 and projections on Q3 higher than 2%). G4 Cash Flow minus Capex spread remains high and positive, net equity issuances low, while buybacks linger. Central banks are also becoming more accommodative, which will improve financing conditions and, finally, ex-US valuations are not expensive.**
- **We remain on the cautious side but, as historical experience shows, panic is enemy of wise decisions. Fundamental conditions remain decently good for the time being and markets are repricing high positioning and Tech euphoric sentiment which could lead to better entry point in the future. In Europe we keep the preference for UK or for Europe Ex Emu vs Emu. We stay tactically prudent on US stocks, with most of the Mag 7 reporting this week.**

Markets were spooked by the sharper deterioration of the US labour market and by the fear that, the easing bias introduced by the Fed for its September meeting may have come too late and that it is ultimately behind the curve in fighting a possible downturn. Here's a **list of the main events**:

- On Wednesday, the **BoJ** raised the Policy rate to 0.25%, earlier than most analysts expected and with data providing only mixed evidence of sustained inflation and hinting at pocket of weakness in the economy.

- On Wednesday night, the Fed opened the door to a September rate cut, without providing more guidance on what it will do next. Chair Powell reckoned that **the state of the labour market is now much more relevant for monetary policy and warned about the risk of its quick deterioration.**

- On Thursday the July manufacturing ISM headline index extended its fall to 46.8, the lowest level since the pandemic outbreak. **The Employment index plunged to 43.4 from 49.3 in June and is now at level comparable to the summer 2020.**

- On Friday the July **nonfarm payrolls came weaker than expected (114K against expectations of 175K), with the private sector adding just 94k jobs**. Moreover, **the unemployment increased for the fourth straight month, to 4.3%**. Tris triggered the "Sahm rule" which in the past has signalled a recession.

- In the euro area, while the first Q2 GDP release surprised to the upside (0.3% qoq), **activity in Germany contracted and key sentiment indicators like the composite PMI have weakened.** Despite persistently strong inflation prints, lower (market-based) inflation expectations global growth fears **triggered a sharp repricing of ECB rate cuts**. At the time of writing markets are now looking for three more 25 bps cuts this year (from currently 3.75%) and see the deposit rate at 2.0% by year-end 2025. This very dovish view implies a swift return towards inflation target, something we only deem consistent with a recessionary development. **We stick to our view of a year-end 2025 key rate of 2.5%.**

FOMC planned speeches/interviews

Today at 11 PM. San Francisco Fed Daly speaks about monetary policy
On Thu. at 9 PM Richmond Fed's Barkin speaks at the Association of Business Economists.

Signs of a weakening of the economy were already evident. Data for June and July show a quicker and mode abrupt response of the labour market. However, we think there are some **mitigating factors**:

- The current spike in the unemployment rate is mainly due to **more people entering the labour market than workers losing their job**. In the past, when the Sahm rule correctly indicated a recession, the opposite was true. Moreover, July showed a very high number of people only momentarily jobless.

- JOLTS data (for June) shows a weakening in job creation, with the hiring rate at its lowest level since April 2020, but not a collapse. Indeed, **the layoffs rate decreased and is at its lowest level since April 2022**.

- The **ISM index for services, a much larger part of the Economy than Manufacturing, beat expectations in July, and continue to signal expanding activit**y and weak, but still positive job creation.

- Consumers still have money: **Real disposable income was up 1.1% year on year in June** and should benefit from lower inflation going forward.

➔ All in all, we do see the US economy weakening, **with GDP dropping to an annualised growth rate of around 1.6% in H2 against the 2.1% observed in H1, with odds of a recession at the beginning of 2025 raised to around 1 in three from 15%.**

The recent batch of data **will urge the Fed to cut rate quickly, and our baseline scenario is shifting to one 25 bps cut at each of the remaining 2024 meetings (Sept., Nov. and Dec.).**

The combination of weak economic data and a dramatic repricing of key rate expectations has led to a **50 bps decline in 10-year Bund yields and a more than 70 bps drop in 10-year US yields since the beginning of July**. The massive bond rally has also been supported by rising geopolitical tensions, the Harris candidacy for the Democratic presidential nomination (unwinding of the "Trump trade"), and, especially in recent days, the risk-off sentiment in global financial markets.

Given the uncertain macro data situation and the marked increase in bond market volatility, **we cannot rule out a further decline in yields short term** – more so that liquidity is traditionally low in August, favouring sharp swings.

However, the recent moves may reflect some over-reaction**, especially for long-term Bund yields**. The key rate cuts expected by the market by the end of 2025 (ECB: more than 150 bps, Fed: 225 bps) appear excessive. The medium-term key rate levels (5 years ahead) priced in for the ECB (2.25%) and the Fed (3.1%) also appear slightly low relative to our estimate of neutrality. Accordingly, long duration positioning at current yield levels have become less attractive.

EA non-core government bond spreads also appear vulnerable to further widening. The 10-year OAT/Bund spread has already returned to end-June levels (80bp). We therefore maintain our cautious view there, as well as non-core bonds. Fiscally weaker countries that have recently outperformed (e.g. Italy) should remain underweighted relative to countries with strong fundamentals.

In credit markets, **the recent concerns about the strength of the US economy haven't really translated into massive HY/IG decompression** neither Fins/Non-fins decompression for now, which is somewhat surprising. CDS have logically under-performed cash, given their higher correlation to equity markets.

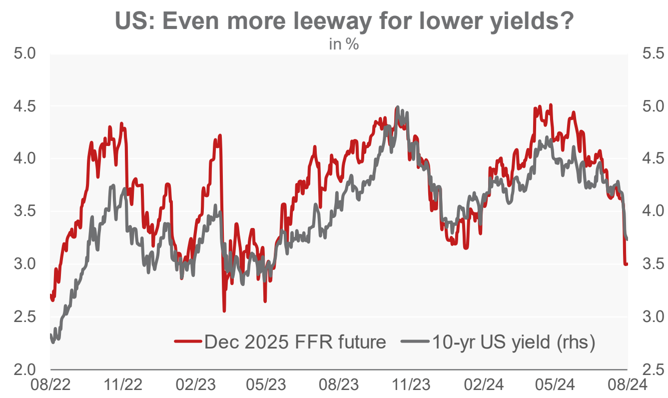
Cash, both IG and HY, has largely be more resilient than equities given the residual demand driven by the elevated all-in yield and the absence of supply over summer months and the low share of tech in credit indices especially in Europe. If fears of US recession are confirmed spreads will have to reprice further but **we remain relatively constructive for now given our expectations that 1/ defaults have peaked already 2/ technical will remain strong on reasonable supply meeting resilient demand 3/ attractive carry versus government bonds.**

Equity market carried some risks before the current slump started, in particular high positioning, declining macro surprises and elevated US valuation. French politics added to the negatives. Since then, the US soft landing certainty has been put in question, recession chances have increased, together with raising **doubts about AI returns on huge capex expenditures and disappointing consumer-related firms' results**. In Asia, a hawkish BoJ has contributed to a sharp yen rebound, which has weighed on the Topix. The result is that from peak, the Topix is down around 20%, EM 6%, the S&P 500 9%, the Nasdaq 17% and the Stoxx 50 nearly 13%.

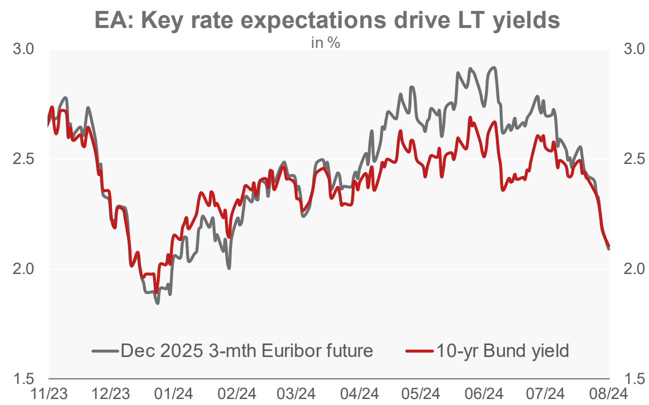
As the VIX nearly doubled since mid-July, markets remain under pressure, as elevated investor positioning may need more time to normalise. Furthermore, sharp increase in volatility and carry trade reversal (Yen) could also trigger some stress in small financial/AM companies. Lastly, spike in volatility tends to undermine corporate confidence.

On the positive side, **the overall reporting season, after nearly 380 (out of 500) US firms reporting, shows a 5pp positive earnings surprise, similarly to Europe (300 reported on 514)**. US unit labour costs look supportive for firms' margins and US GDP numbers are not falling over the cliff (Q2 and projections on Q3 higher than 2%). Furthermore, some relevant market technical look rather safe: G4 **Cash Flow minus Capex spread remains high and positive**, net equity issuances low, while buybacks linger. Central banks are also becoming more accommodative, triggering better financing conditions ahead and, finally, **ex-US valuations are not expensive**. For what is worth, optimism among mid-market business leaders (last Grant Thornton's Int. Business Report) has rebounded to pre-COVID levels, with a record 71% of leaders optimistic about the next 12 months.

In conclusion, short term, risk do linger but as historical experience shows, panic is enemy of wise decisions. Fundamental conditions remain decently good for the time being and markets are repricing high positioning and Tech euphoric sentiment which could lead to better entry point in the future.



Source: Bloomberg, GenAM



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