SINGALLIANCE

Letter n°94

A year under the sign of vigilance

"In politics, what is often most difficult to appreciate and understand is what is happening before our eyes" Tocqueville.

This illustrious word from Tocqueville can actually be applied to economics and financial markets. The year 2023 recorded astonishing performances as it took place in a climate of high pessimism. The year 2024, in a kind of mirror effect, could experience the opposite destiny.

Let us explain. At the beginning of 2023, we were among the few who did not share fears of a recession in the United States and did not consider the return of inflation to be structural. Recession fears, inflation fears, two scarecrows for the markets, two factors of concern.

What happened? The feared recession in the United States gave way to a year of growth above the long-term trend. The rapid and substantial increase in interest rates did not lead to an increase in unemployment and did not trigger a housing crisis.

On the other hand, the expected recovery in China, after mishandling Covid, failed, causing another year of decline in the stock market.

Finally, concerns about a surge in commodity prices did not materialize.

What to watch out for in 2024? The World Bank anticipates a slowdown this year to 2.4%, after 2.6% in 2023 and 3% in 2022. The growth for the period 2020-24 is thus the lowest in the last 30 years since the 1990-94 period.

In this context, three points of vigilance will be analysed: first, geopolitical vigilance, then vigilance on corporate margins, and finally, vigilance on the pace of interest rate cuts.

Geopolitical vigilance:

There have never been as many armed conflicts since 1945, but stock markets have recorded a remarkable increase. As detailed in our Letter 43, geopolitical crises affect markets from time to time, but not durably, and this has been verified in the worst moments of the 20th century, such as during the Second World War or more recently, with the Gulf War in 1990.

At the beginning of this year, four subjects are capturing attention:

- ***The various elections***:

There will be 70 elections worldwide in 2024, but the markets seem to have little apprehension about the results. In the European Parliament, components of the far right are expected to gain seats but not the majority.

In India, continuity should prevail. Modi is expected to secure a new mandate, but a victory for his main opponent would be a good way to counter current drifts.

In South Africa, the ruling party is expected to stay in power. In Mexico, Lopez Obrador cannot run again, but we don't foresee any problems.

In fact, of all these elections, the worst risk would be the return of Trump to power, but we will revisit this risk in upcoming Letters.

- ***The war in Ukraine***:

The blitzkrieg envisioned by Putin is a war of positions with no progress on either side. Two years ago, before the conflict, Russia occupied 18% of Ukrainian territory. Today, after over 300,000 deaths on the Russian side, probably double the number of wounded, and nearly a million people leaving Russia to avoid conscription, Russia struggles to maintain the war effort and keep hold of the occupied territories, representing barely more than 0.1% of Russia's territory.

A disproportionate military budget of $106 billion, over 6% of GDP, public expenditures sacrificed to finance this effort, an inflation rate of 7.5%, detrimental to purchasing power as interest rates had to be raised to 16%, a call for North Korean assistance for ammunition and Iranian assistance for the supply of drones and missiles—two of the least reputable regimes on the planet.

What are the results? Ukraine, despite its difficulties, deprived of ammunition and temporarily without the $60 billion American aid, while awaiting hypothetical European aid of €30 billion, has resisted and has not relinquished territory in recent months.

For the markets, the initial shocks of this war on food prices, gas, and oil prices have dissipated. Regarding foodstuffs, Ukraine has managed to secure a flow corridor in the Black Sea. Concerning gas, European reserves are 90% full, and dependence on Russian gas has been reduced to 14%, compared to 60% before the conflict. As for oil prices, the record production from the United States, 13.2 million barrels per day, Canada (a doubling in the last ten years), and dissensions within OPEC have weighed on the barrel price, which is currently at $77/b, compared to nearly $100/b a year ago.

- ***The war against Hamas***:

The risk would be an extension of the conflict, hence the vigilance, but regional actors, all facing economic difficulties, are cautious and not yielding to street pressures.

Even before the partial and temporary deprivation of revenue from the Suez Canal, $8 billion a year, due to the diversion of ships around the Cape of Good Hope, Egypt is faced with a wall of foreign debt, $165 billion, and a public debt of 90% of GDP. Its Saudi and Emirati backers are weary of injecting money, and the IMF has already been heavily solicited.

Lebanon, in bankruptcy, has still not met the conditions for a $3 billion IMF loan, so Hezbollah must bide its time.

Syria is no longer an economy and is mainly sustained by its sales of synthetic drugs and Iranian aid.

The Iranian economy and its population of 85 million are weakened by international sanctions and would fear, in the event of war, exposing its nuclear facilities to Israeli fire.

- ***Risks regarding Taiwan***:

This, of course, is the major risk. Whatever the outcome of the 13 January election, Taiwan will remain committed to democratic elections and China will remain opposed. Taiwan is de facto an independent state and will refrain from proclaiming "de jure" independence to avoid offending China and pushing it into war.

The United States has been committed since 1979 through the Taiwan Relations Act, which, in the event of a Chinese attack, does not necessarily mandate direct American military intervention but at least the provision of means of defense, especially considering Biden's apparent interventionist stance.

Japan is now tying its defense to that of Taiwan, as its westernmost island is only 110 km from Taiwan but its support would likely be only logistical.

A war would cause a recession in all countries because the semiconductor sector, dominated by Taiwan and TSMC, represents $6 trillion, or nearly 6% of the global GDP, with applications in many sectors.

The recession would be more severe in China, -16% according to Bloomberg estimates, than in the United States, -6.7%, and the inevitable trade sanctions would be more detrimental than for Russia because China is more dependent on international trade for its growth.

Rationally, China has little reason to attempt to invade Taiwan. Judging by the recent changes in generals and the sudden replacement of the Minister of Defense, there are issues in the chain of command. The human and economic costs of an invasion attempt would be enormous. However, being in an autocratic regime, and considering that, rationally, Russia had no more reason to engage in the war of attrition in Ukraine, let's remain vigilant, as global stock markets would plummet.

Vigilance on profit margins:

In 2023, the earnings growth of the MSCI World was zero, but markets appreciated, making them more expensive today, with a price-to-earnings ratio of 20x for S&P500 companies and 30x for the Nasdaq.

In 2023, in an inflationary context, most companies were able to preserve their margins through price increases, sometimes exceeding cost increases.

In 2024, markets anticipate a 10% increase in global profits, but this seems optimistic and subject to disappointments.

In a context of disinflation and lower consumer dynamism, with productivity stagnation, price increases may prove challenging, and we will monitor the evolution of margins. Disappointments in results could occur, and we know how abruptly they are punished in the stock market.

More specifically, in the banking sector, an increase in corporate default rates and a decrease in loan volumes could affect the profitability of retail banks.

Adding to the margin evolution in all sectors, but more specifically in services, is the rigidity of wage growth. While employees lost purchasing power in 2021 and 2022 due to inflation outpacing salary increases, this year the trend will be the opposite.

Finally, many indebted companies will face the maturity of loans obtained a few years ago under favourable conditions and will have to renegotiate at higher rates. Therefore, it is advisable to avoid investing in these indebted companies.

Vigilance on rate cuts:

The performance of bond markets in the last two months of the year was unprecedented in 40 years. It allowed, after two years of declining bonds, to finish the year on a positive note, with +8% for Euro-denominated sovereign bonds, +4% for U.S. bonds, and +8.5% for corporate bonds in both € and $ — a performance that was unimaginable at the end of September.

Faced with the decline in long-term rates, from 5.02% for the U.S. 10-year bond to 3.80%, euphoria has gripped many operators who now anticipate up to six interest rate cuts in 2024, with the first expected in March.

Even though we have never doubted the transient nature of inflation, we remain sceptical. Firstly, the current tensions off the Houthi coast, a transit point for 12% to 15% of the world's maritime trade, are pushing up freight costs, doubling or even tripling them, and if they continue could have a knock-on effect on cost inflation.

Secondly, the persistence of wage increases in a job market that is still tight in certain sectors could encourage central banks to temporize, to defer their interest rate cuts.

Finally, the resistance to the decline in long-term rates will result from exacerbated debt levels worldwide and increased financial needs to finance the energy transition, the rise in defense budgets, and the consequences of demographic aging.

In ***conclusion,*** let us recall the words of ***Paul Valéry***, " History, I fear, does not allow us to make predictions; but associated with independence of mind, it can help us see better."

This is just a preliminary overview of the year. We will have the opportunity to delve more into each of these points in upcoming Letters. However, it is useful to have a compass, a tone.

There is no sense of foreboding, but a shadow looms over the markets, calling for vigilance.

Vigilance does not rule out opportunities in the markets, and we particularly recommend buying more defensive positions, a higher weighting in bonds than before, maintaining a presence in oil — considered a better hedge against the occurrence of a geopolitical crisis — reducing exposure to the banking sector, and being more responsive in portfolio management.

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