



MACRO – OUTLOOK Q4 2023

The core thesis in this Quarterly Outlook is that real rates are too positive, creating a fallout from sectors and consumers with refinancing needs. Nominal rates are a burden too, with mortgage rates for long maturity at 7.5%, although our estimation is that new homeowners and refinancing will be done at variable rates. As spending is likely to slow and the US fiscal cycle is turning from tailwind to headwind, the world may indeed have reached 'peak rates', providing a once-in-a-decade opportunity to go long bonds. (vide our recent trade idea on 20y + ETF TLT)

In FX, the USD continues to be strong, and with the increased stagflation risks in Europe and the UK, combined with a structurally weak Chinese economy hit by balance sheet recession dynamics, the USD could extend its momentum, despite a pricing of 'peak rates' and rate cuts in 2024. One sign of 'peak rates' is the emerging market rate cut cycle that has already begun in Brazil, China and Poland.

In equities, the central banks' fight against inflation has pushed cost of capital to levels that are beginning to weigh on the global economy. The capital-intensive industries in the green transformation have been the hardest-hit and herein lies the political motivation for lowering interest rates: the green transformation is not sustainable at current interest rate levels and commodity prices. In the case that 'peak rates' are here, and spending slows with Europe in stagflation, defensive sectors are expected to deliver the best returns (or the least worse).

In bonds, the stagflation risks and 'higher for longer' observed through inflation expectations and lately driven by higher energy prices (albeit corrected very recently) may pose a timing threat to our long bonds theme. However, an economic downturn, as the lagged effects of the recent rate hike cycle kick in, will force central banks into cutting interest rates (est. 2nd half 2024), lowering the short-end of the US yield curve and, as the effects deepen, the long-end of the yield curve will follow lower, reflecting the need for lower long-term real rates or even negative real rates.

In commodities, the big action in the third quarter was in energy prices led by oil and we expect supply tightness, not only in energy but all commodities, to extend the momentum in commodity prices. That will underpin inflation and stagflation risks, but also put pressure on central banks to offset this constraint by lowering real rates.

Often big turning points in financial markets such as 'peak rates' are forced upon central banks through a liquidity event. The US Treasury, the deepest and most liquid pool of safe government securities, experienced a seismic shift during the early days of the pandemic, illuminating a potential underlying risk to the financial system. As time has passed, the US government has dramatically increased its issuance of government bonds



to support the USD 1 trillion in additional fiscal spending by the Biden administration. This pace is at odds with the capital constraints faced by primary dealers and the complexity of the US Treasury market and regulatory constraints could spark a liquidity event.

Following the longest drawdown in US 10-year Treasury bonds in half a century and shunned by investors, bonds in all shapes may soon come into fashion again. In an economic slowdown, bonds add critical diversification benefits to portfolios and the current levels of interest rates have also raised the carry returns to levels that significantly reduce further downside risks from here. Increased bond exposure in portfolios at this point adds an asset with a good risk-reward ratio and some hedging against a slowing economy.

Economic Impact of War

Global growth and inflation impact of three scenarios for how the Israel– Hamas conflict could evolve

Scenario	Details	Impact on oil prices and VIX*	Impact on global GDP and inflation**
Confined war	- Ground invasion of Gaza - Limited broader regional conflict - Lower Iranian crude output	Oil: +\$4/barrel VIX: No impact	GDP: –0.1 ppts. Inflation: +0.1 ppts.
Proxy war	- Multifront war in Gaza, West Bank, Lebanon, Syria - Unrest in wider Middle East	Oil: +\$8/barrel VIX: +8 points	GDP: –0.3 ppts. Inflation: +0.2 ppts.
Direct war	- Israel and Iran in direct conflict - Unrest in wider Middle East	Oil: +\$64/barrel VIX: +16 points	GDP: –1.0 ppts. Inflation: +1.2 ppts.

Source: Bloomberg Economics

*Impact calibrated based on 2014 Gaza War, 2006 Israel–Lebanon War, and 1990–1991 Gulf War. **Impact on year on year change in global GDP and inflation for 2024, estimated using Bayesian Global VAR

Bloomberg

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