SoundCapital™

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SoundInsight N°21

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Double rate cut sparks discussions

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Recession likelihood decreases

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Unchanged positioning

The Big Pivot

The long-anticipated shift in US interest rate policy has finally materialized. Following over two years of rising and historically elevated rates, a double rate cut now signals a pivotal moment, carrying substantial implications for capital markets.

At the beginning of 2023, the US market anticipated an interest rate reversal by year-end. However, strong economic growth and persistently high inflation shifted expect-ations. The Federal Reserve continued rai-sing rates until July 2023, ultimately holding the benchmark rate steady at 5.5% - the highest level since 2001. With the release of the Fed's cautious economic outlook in the September Beige Book, clear signs of an impending policy shift emerged. None-theless, the Federal Reserve surprised many by implementing a 0.5% rate cut this month, equivalent to two standard 0.25% reductions. Out of 113 economists surveyed, only nine had predicted such a move.

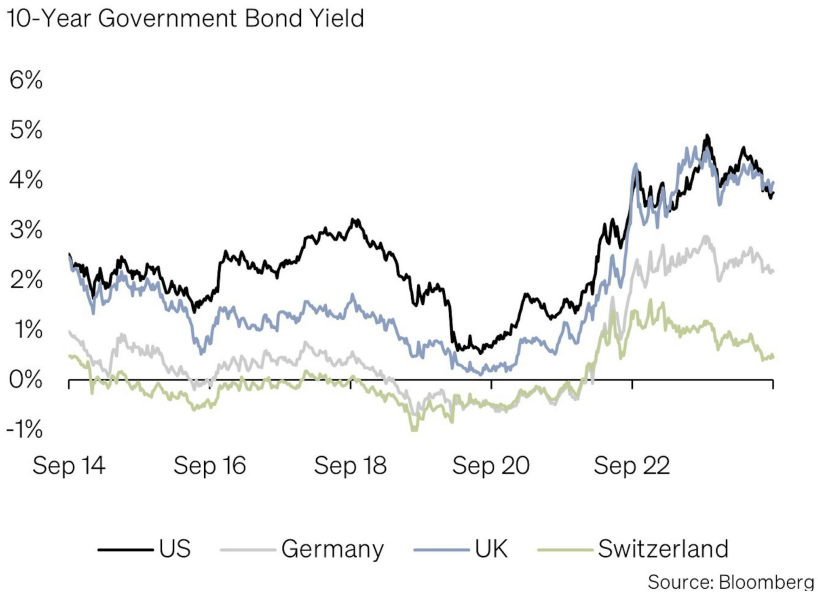
This double rate cut caught many market participants off guard and ignited wide-spread debate. Federal Reserve Chairman Jay Powell addressed the reasoning behind the decision during a press conference. Historically, cuts of this magnitude have been tied to recessionary periods (e.g., the dot-com bubble, the Lehman crisis, and the COVID-19 pandemic). However, the current inflationary environment is different.

Despite the rate cut, the official forecasts released alongside the decision do not suggest an impending recession. Inflation appears to be under control, and the labor market is stabilizing. This view is shared by many economists, with expected recession risk for the US over the next year dropping from 50% at the start of the year to 30%.

With the magnitude of this rate cut, the Federal Reserve is signaling a proactive approach to mitigating the risk of a significant economic slowdown, ideally addressing it before it becomes a larger issue. The markets have already priced in expectations for up to eight additional rate cuts by the end of 2025. As a result, businesses are already benefiting from lower borrowing costs, and default probabilities remain at historically low levels, providing crucial support, particularly for capital-intensive sectors.

These developments suggest a favorable backdrop for equities and higher-risk assets. Analysts are projecting broad-based earnings growth for S&P 500 companies in the coming year. While major tech stocks have driven much of the growth and returns in recent quarters, a significant portion of 2025's earnings growth is expected to come from sectors outside of technology and communication. Hence, for value stocks, which experienced no growth this year, analysts are forecasting a growth surge of over 10% in 2025.

As a result, markets are currently pricing in an optimistic outlook: a stabilizing US economy aided by rate cuts, historically low credit spreads, cheaper financing for companies, and double-digit earnings growth. However, the August jobs report and several leading indicators suggest that potential disappointments cannot be ruled out. Given these factors, we are maintaining a neutral allocation between bonds and equities. Sensitivity to economic data will remain elevated ahead of the US elections, making a focus on quality and stability within portfolios a prudent strategy.



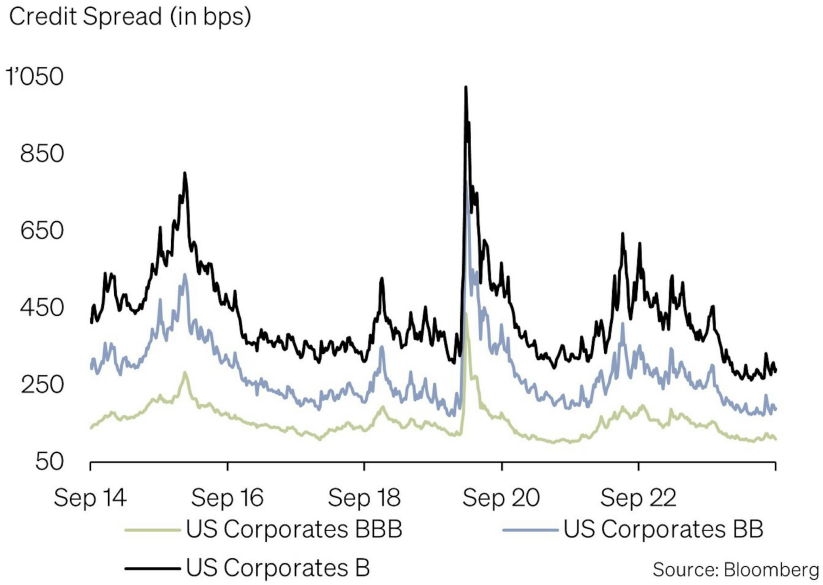
Source: Bloomberg

Yields

The long-standing yield curve inversion, where two-year government bonds yielded more than ten-year bonds, has corrected with the recent shift in interest rates. However, central banks' efforts to ease economic conditions while stock markets remain at record highs present a risk of reigniting inflation. In our view, current interest rate levels are moving toward a neutral stance. At this time, we continue to favor slightly longer maturities in USD and GBP, while maintaining a preference for shorter maturities in EUR and CHF.



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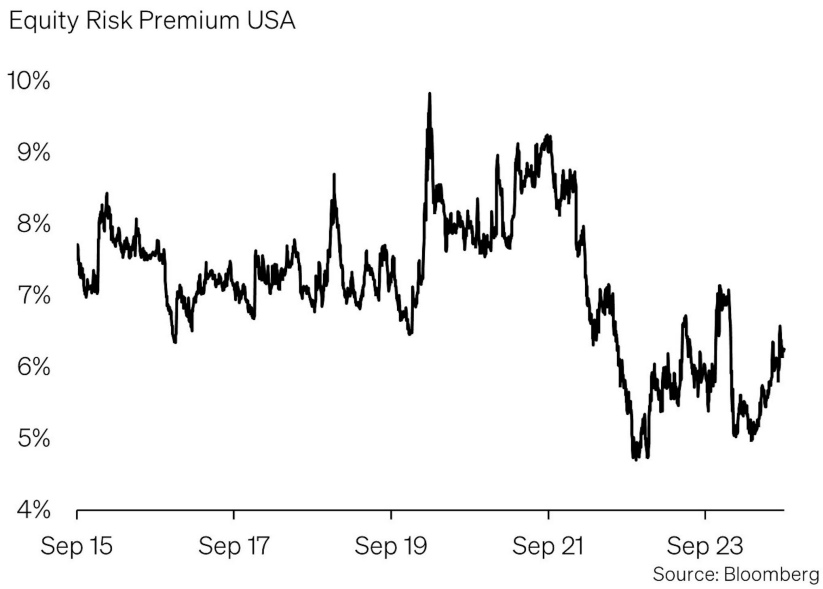
Source: Bloomberg

Spreads

Current credit spreads reflect expectations of a soft economic landing and indicate that companies may benefit from lower interest rates going forward. We anticipate that opportunities for higher credit spreads could arise in the coming months, reinforcing our continued preference for quality investments.



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Equity Risk Premium

With lower interest rates, declining inflation and increasing earnings expectations, risk premiums for equities are moving up one notch. However, they remain at low levels and are not yet at a neutral level.



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Manufacturing PMI

	Dec 22	Jan 23	Feb 23	Mar 23	Apr 23	May 23	Jun 23	Jul 23	Aug 23	Sep 23	Oct 23	Nov 23	Dec 23	Jan 24	Feb 24	Mar 24	Apr 24	May 24	Jun 24	Jul 24	Aug 24	Sep 24
Global	48.7	49.1	49.9	49.6	49.6	49.5	48.7	48.6	49.0	49.2	48.8	49.3	49.0	50.0	50.3	50.6	50.3	51.0	50.8	49.7	49.5	
USA ISM	48.1	47.4	47.7	46.5	47.0	46.6	46.4	46.5	47.6	48.6	46.9	46.6	47.1	49.1	47.8	50.3	49.2	48.7	48.5	46.8	47.2	
Europe	47.8	48.8	48.5	47.3	45.8	44.8	43.4	42.7	43.5	43.4	43.1	44.2	44.4	46.6	46.5	46.1	45.7	47.3	45.8	45.8	45.8	44.8
United Kingdom	45.3	47.0	49.3	47.9	47.8	47.1	46.5	45.3	43.0	44.3	44.8	47.2	46.2	47.0	47.5	50.3	49.1	51.2	50.9	52.1	52.5	51.5
Switzerland	54.5	49.3	48.9	47.0	45.3	43.2	44.9	38.5	39.9	44.9	40.6	42.1	43.0	43.1	44.0	45.2	41.4	46.4	43.9	43.5	49.0	
China Local	47.0	50.1	52.6	51.9	49.2	48.8	49.0	49.3	49.7	50.2	49.5	49.4	49.0	49.2	49.1	50.8	50.4	49.5	49.5	49.4	49.1	
Japan	48.9	48.9	47.7	49.2	49.5	50.6	49.8	49.6	49.6	48.5	48.7	48.3	47.9	48.0	47.2	48.2	49.6	50.4	50.0	49.1	49.8	49.6

Services PMI

	Dec 22	Jan 23	Feb 23	Mar 23	Apr 23	May 23	Jun 23	Jul 23	Aug 23	Sep 23	Oct 23	Nov 23	Dec 23	Jan 24	Feb 24	Mar 24	Apr 24	May 24	Jun 24	Jul 24	Aug 24	Sep 24
Global	48.0	50.0	52.5	54.3	55.2	55.3	53.8	52.6	51.0	50.7	50.4	50.7	51.6	52.3	52.4	52.4	52.7	54.0	53.1	53.3	53.8	
USA ISM	49.0	54.7	55.0	51.2	52.3	51.0	53.6	52.8	54.1	53.4	51.9	52.5	50.5	53.4	52.6	51.4	49.4	53.8	48.8	51.4	51.5	
Eurozone	49.8	50.8	52.7	55.0	56.2	55.1	52.0	50.9	47.9	48.7	47.8	48.7	48.8	48.4	50.2	51.5	53.3	53.2	52.8	51.9	52.9	50.5
United Kingdom	49.9	48.7	53.5	52.9	55.9	55.2	53.7	51.5	49.5	49.3	49.5	50.9	53.4	54.3	53.8	53.1	55.0	52.9	52.1	52.5	53.7	52.8
Switzerland	49.5	56.7	55.3	54.2	52.2	52.6	49.6	42.7	50.3	52.8	52.2	53.6	56.9	54.6	53.0	47.6	55.6	48.8	52.0	44.7	52.9	
China Local	39.4	54.0	55.6	56.9	55.1	53.8	52.8	51.5	50.5	50.9	50.1	49.3	49.3	50.1	51.0	52.4	50.3	50.5	50.2	50.0	50.2	
Japan	51.1	52.3	54.0	55.0	55.4	55.9	54.0	53.8	54.3	53.8	51.6	50.8	51.5	53.1	52.9	54.1	54.3	53.8	49.4	53.7	53.7	53.9

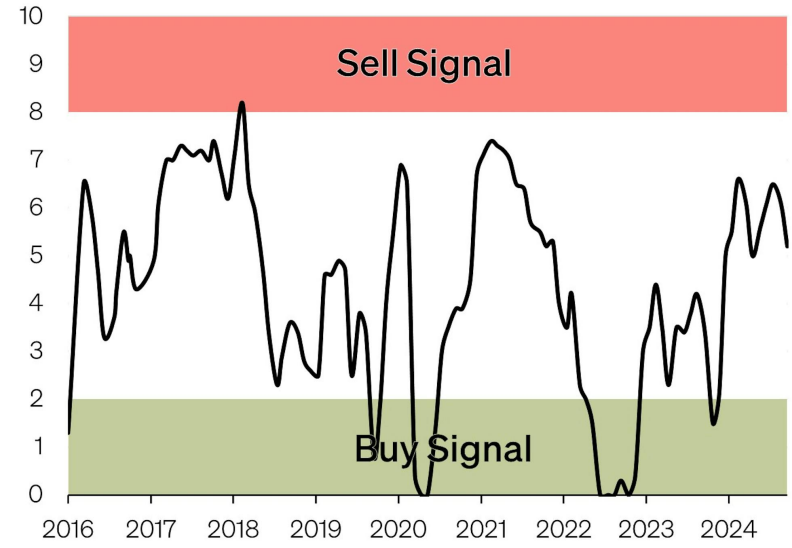
Description: The Purchasing Managers' Index (PMI) is a forward-looking economic indicator based on company surveys. A value above 50 indicates an improving economic environment, whereas a value below 50 indicates a worsening environment.

Leading Indicators

Leading indicators, particularly in the industrial sector, show little evidence of a soft economic landing. While the service sector is delivering strong results, the manufacturing industry continues to struggle with a lack of positive momentum that is crucial for sustaining a stable economic trajectory in the months ahead.



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Risk-Index

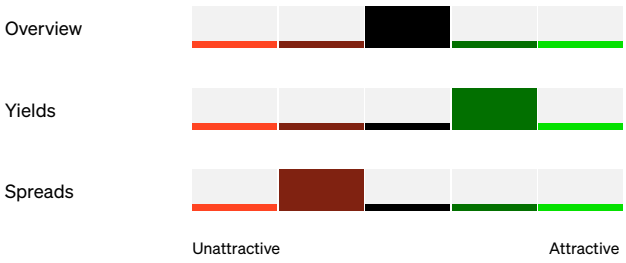
The risk index has slightly declined over the past month but remains in neutral territory.



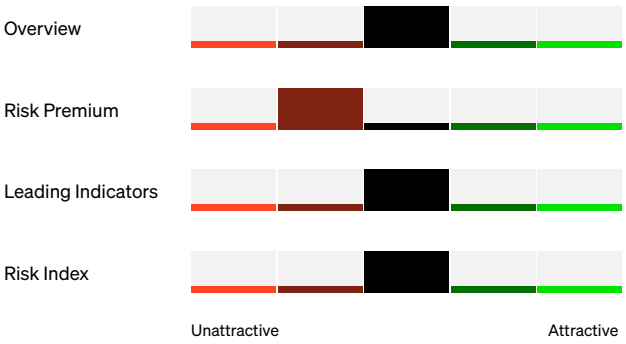
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SoundCapital™

Bonds



Equities



Appendix

Sound Invest is the central tool for our investment allocation. We use it to systematically and consistently assess the aspects that are relevant to the development of the financial markets. As a result, our clients can rely on a rational and anti-cyclical implementation of our investment decisions.

- **Focusing on the essentials** Interest rate level, risk premium, valuation, economic development, investor sentiment and positioning. These are the decisive factors for success on the financial markets, especially in turbulent times when the temptation to react irrationally to the headlines is particularly strong.
- **Comparability over time and place**
  The factors mentioned above are equally relevant for all markets and at all times. This is the result of a strict «backtesting» process that continues into the future.
- **Cumulating our investment experience**
  Our strength lies in the many years of experience of our partners and principals. It is precisely this experience that we summarize and make it applicable with Sound Invest.
- **Transparency**
  Thanks to our monthly publication, our clients always know where we stand in the investment cycle and how we expect the financial markets to develop.

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