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SoundInsight N°8

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Inflation continues to fall

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Central bank policy converges

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No debt relief for student loans

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Alternative Investments reduced to underweight

Final Stretch for Central-Bank Tightening

Lowest US inflation since spring 2021 paves the way for what is expected to be the Fed's last rate hike in the current cycle.

The US continues to experience a decline in inflation, with June reporting the lowest figure since 2021 at approximately 3%. A noteworthy aspect of this development is the persistent core inflation, excluding food and energy, which has significantly dropped to 4.8% year-over-year, a more substantial decrease than anticipated by economists. This suggests that the impact of the preceding 500 basis points of interest rate hikes is gradually materializing, potentially paving the way for a final interest rate hike by the Federal Reserve at the end of this month.

Analysts observe a disinflationary trend in the current data, coupled with an economic slowdown. Bloomberg's projections indicate that inflation in the US is expected to fluctuate between 0.2% and 0.3% monthly until the end of the year, inching closer to the Federal Reserve's 2% annual target. However, the journey towards achieving this target is likely to be challenging. Estimates indicate that the Consumer Price Index will witness a 3.4% year-on-year increase in July and a 3.6% rise in August, attributed to a less favorable base effect compared to June. Nonetheless, overall inflation for 2023 is predicted to remain slightly above 3%.

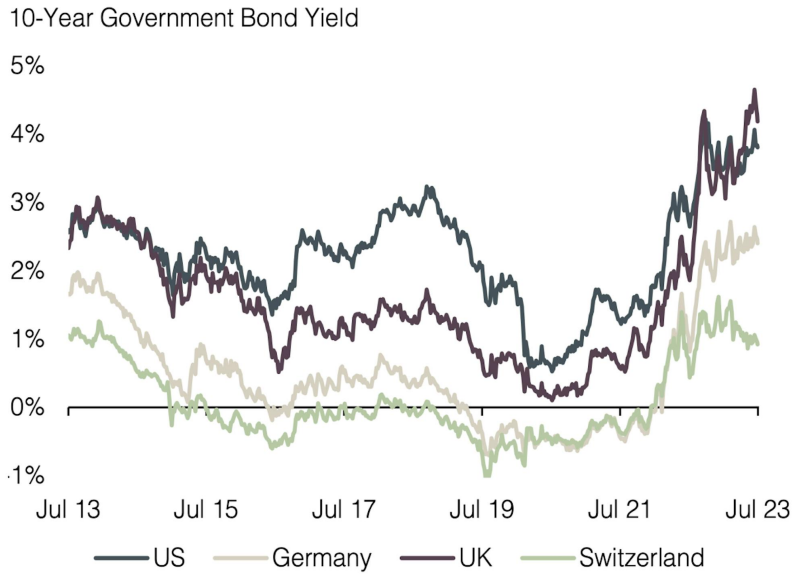
The market expects the Federal Reserve to hike one last time by the end of this month, while the European Central Bank (ECB) is poised to add two more interest rate hikes before year-end. This indicates a potential convergence of international monetary policies in the coming months. Although the Federal Reserve has made considerable progress in its efforts to fight inflation, central bank policy rates are expected to continue climbing across other global regions until year-end. This anticipation has led to a narrowing interest rate differential between US dollar-denominated investments and other assets. The interest rate spread between a 1-year USD government bond compared to a 1-year German government bond has halved in recent months, contributing to a weakening US dollar. Hence, a declining USD could potentially exert inflationary pressure on the US, being a net-importing country.

Considering recent economic developments, it remains evident that central banks continue to rely on indicators such as the job market, despite their delayed reflection of the economic situation. This focus on lagging data increases the possibility of unexpected outcomes. While the likelihood of a "soft landing" for the US economy, potentially avoiding a recession, is gaining traction, worrisome signs are emerging, particularly concerning consumers. Instances of delinquencies in consumer credit, including auto leasing and credit card

payments, are on the rise. Moreover, Bloomberg's estimations suggest that households with lower incomes have significantly depleted their savings.

Adding to these concerns is the upcoming end of the COVID-related student loan deferral program, scheduled for late August. This development could place an additional burden on many households' finances. Notably, US student loan debt exceeded a staggering $1.75 trillion in 2022, making it the second-largest form of consumer debt after real estate mortgages. President Joe Biden's plan to forgive up to $20,000 in federal student loan debt for eligible borrowers was rejected by the US Supreme Court at the end of June. Consequently, interest on student loans will resume on September 1, 2023, affecting approximately 44 million individuals, a quarter of the American workforce.

While these effects may impact the economy with a delay, we concur with Bloomberg economists that the macroeconomic environment is poised for negative developments in the coming months. As a result, adopting a cautious positioning is prudent, and the prevailing low volatility in the stock market presents a favorable opportunity for implementing hedging strategies. Our investment approach retains a neutral allocation to bonds while maintaining an underweight position in the equity space. Given the increasing visibility on inflation and short-term interest rates, we are seizing the moment to reduce alternative investments and prioritize liquidity. This strategic shift is motivated by the stable yield and low volatility that liquidity provides, affording us enhanced flexibility to capitalize on upcoming market opportunities amidst the current economic climate.

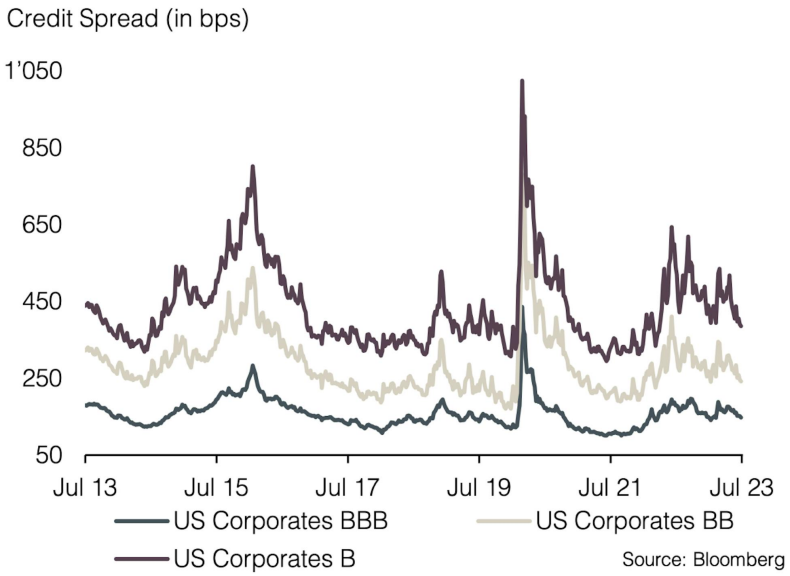


Yields

USD interest rates have experienced quite a rollercoaster ride over the past month. Consequently, it comes as no surprise that the interest rate volatility, measured by the MOVE index, remains significantly above the long-term average. In stark contrast, the stock market volatility has reached its lowest level since the onset of the pandemic. We continue to assess the current interest rate levels as attractive and recommend gradually extending the maturities in the realm of government bonds in the event of further increases.



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Spreads

Credit spreads for bonds have tightened even further over the past month, keeping them unattractive. Looking ahead, a substantial number of high-yield bonds are due to be refinanced in 2024 and 2025, which will likely put investors' risk appetite to the test. We maintain our cautiously conservative stance and avoid high credit risks.



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Equity Risk Premium

The Shiller equity risk premium in the US has recently hit its lowest level on our records. Furthermore, when compared to other markets, the valuation of the US equity market appears to be expensive. Taking a global perspective into account, stocks remain unattractive due to the unattractive risk premium, leading us to maintain a negative outlook.



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Leading Indicators

Manufacturing PMI

	Oct 21	Nov 21	Dec 21	Jan 22	Feb 22	Mar 22	Apr 22	May 22	Jun 22	Jul 22	Aug 22	Sep 22	Oct 22	Nov 22	Dec 22	Jan 23	Feb 23	Mar 23	Apr 23	May 23	Jun 23	Jul 23
Global	54.2	54.2	54.3	53.2	53.7	53.0	52.3	52.4	52.2	51.1	50.3	49.8	49.4	48.8	48.7	49.1	49.9	49.6	49.6	49.6	48.8	
USA ISM	60.4	60.8	58.6	57.6	58.4	57.0	55.9	56.1	53.1	52.7	52.9	51.0	50.0	49.0	48.4	47.4	47.7	46.3	47.1	46.9	46.0	
Europe	58.3	58.4	58.0	58.7	58.2	56.5	55.5	54.6	52.1	49.8	49.6	48.4	46.4	47.1	47.8	48.8	48.5	47.3	45.8	44.8	43.4	42.7
United Kingdom	57.8	58.1	57.9	57.3	58.0	55.2	55.8	54.6	52.8	52.1	47.3	48.4	46.2	46.5	45.3	47.0	49.3	47.9	47.8	47.1	46.5	45.0
Switzerland	66.3	64.1	64.5	63.7	62.7	63.3	61.6	59.8	59.1	58.0	56.7	56.8	55.4	54.4	54.5	49.3	48.9	47.0	45.3	43.2	44.9	
China Local	49.2	50.1	50.3	50.1	50.2	49.5	47.4	49.6	50.2	49.0	49.4	50.1	49.2	48.0	47.0	50.1	52.6	51.9	49.2	48.8	49.0	
Japan	53.2	54.5	54.3	55.4	52.7	54.1	53.5	53.3	52.7	52.1	51.5	50.8	50.7	49.0	48.9	48.9	47.7	49.2	49.5	50.6	49.8	49.4

Services PMI

	Oct 21	Nov 21	Dec 21	Jan 22	Feb 22	Mar 22	Apr 22	May 22	Jun 22	Jul 22	Aug 22	Sep 22	Oct 22	Nov 22	Dec 22	Jan 23	Feb 23	Mar 23	Apr 23	May 23	Jun 23	Jul 23
Global	55.6	55.6	54.7	51.0	54.0	53.4	52.2	51.9	53.9	51.0	49.2	50.0	49.2	48.1	48.1	50.1	52.6	54.4	55.4	55.5	54.0	
USA ISM	66.6	67.6	61.7	60.4	57.2	58.4	57.5	56.4	56.0	56.4	56.1	55.9	54.5	55.5	49.2	55.2	55.1	51.2	51.9	50.3	53.9	
Eurozone	54.6	55.9	53.1	51.1	55.5	55.6	57.7	56.1	53.0	51.2	49.8	48.8	48.6	48.5	49.8	50.8	52.7	55.0	56.2	55.1	52.0	51.1
United Kingdom	59.1	58.5	53.6	54.1	60.5	62.6	58.9	53.4	54.3	52.6	50.9	50.0	48.8	48.8	49.9	48.7	53.5	52.9	55.9	55.2	53.7	51.5
Switzerland	59.3	59.2	59.9	56.4	64.3	61.1	56.2	59.6	58.1	55.6	56.6	52.8	53.8	53.4	49.5	56.7	55.3	54.2	52.2	52.6	49.6	
China Local	51.6	51.1	52.0	50.3	50.5	46.7	40.0	47.1	54.3	52.8	51.9	48.9	47.0	45.1	39.4	54.0	55.6	56.9	55.1	53.8	52.8	
Japan	50.7	53.0	52.1	47.6	44.2	49.4	50.7	52.6	54.0	50.3	49.5	52.2	53.2	50.3	51.1	52.3	54.0	55.0	55.4	55.9	54.0	53.9

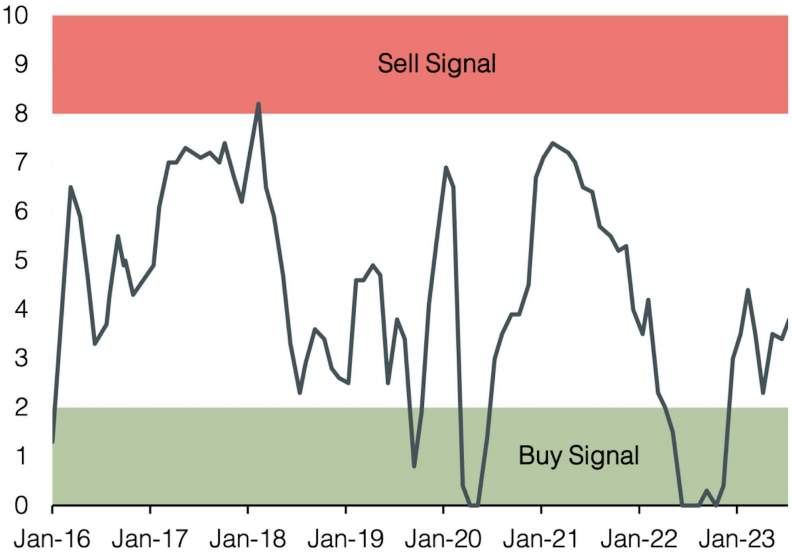
Description: The Purchasing Managers' Index (PMI) is a forward-looking economic indicator based on company surveys. A value above 50 indicates an improving economic environment, whereas a value below 50 indicates a worsening environment.

The negative trend in leading indicators persists. Our current focus is on the significant disparity between the services and manufacturing sectors. Over the next few months, these two areas are likely to converge, with the expectation that the positive prospects in the services sector may moderate.



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Risk-Index



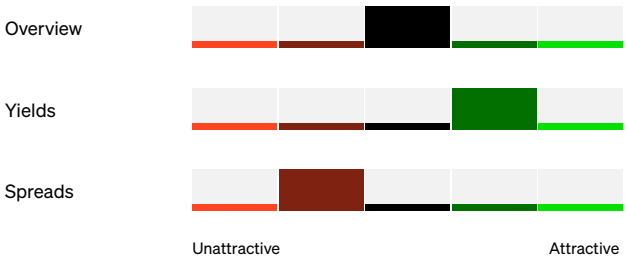
Over the past few weeks, it is evident that investors have taken a slightly more optimistic stance. However, overall, the risk index remains neutral.



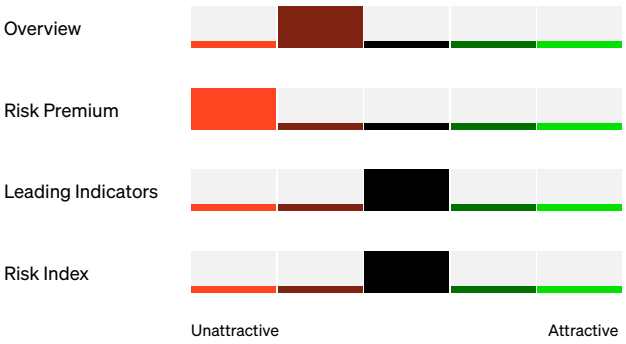
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Bonds



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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Datasource: Bloomberg, BofA ML Research