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INVESTMENT STRATEGY

The curse of the Olympic Games

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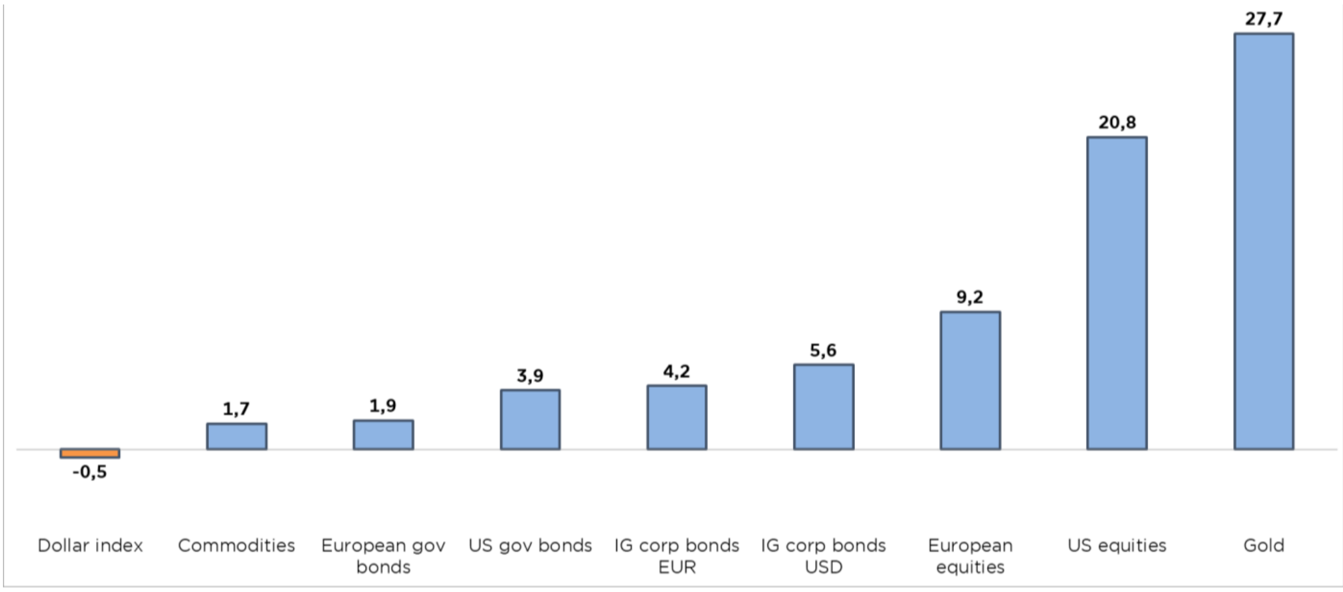
While in many respects the Olympic Games were a success in France, there is an inexplicable inevitability for the host countries: they are often the epicentre of an economic or political crisis some time later. The cost of the 2004 Athens Games contributed to Greece's default. Brazil experienced an economic recession in 2016 just after the Games, not to mention China, which has seen its debt stock grow and its growth weaken since the Beijing Games in 2022. This year, France seems to be following the same disastrous fate with a very deteriorated fiscal trajectory against the backdrop of a political crisis. Of course, the Olympic Games are not the explanation for these phenomena. The primary reason is always debt. Organising major sporting events simply helps to increase the existing debt stock. This summer, the majority of central banks in the developed world seem to have agreed on the need to reduce the cost of debt by cutting interest rates.

A rate cut is a bit like a drop in petrol prices: it is rarely seen as bad news. More specifically, a very large number of consumers view this positively, while a small number of suppliers complain.

The advantage is that over the past few months we have had both: lower oil prices but also (finally) future rate cuts. More money market liquidity in the hands of investors provides strong support for the upward momentum in market prices, as illustrated by performances since the start of the year.

Year-to-date asset class performance as of 09.30.2024 (local currencies)



Year-to-date performance of the main asset classes in local currency.

Source: Bloomberg, Edmond de Rothschild Monaco (Indices used for US and European equities: S&P 500 and Stoxx 600. IG means "Investment grade", i.e. an issuer rating greater than or equal to BBB-)

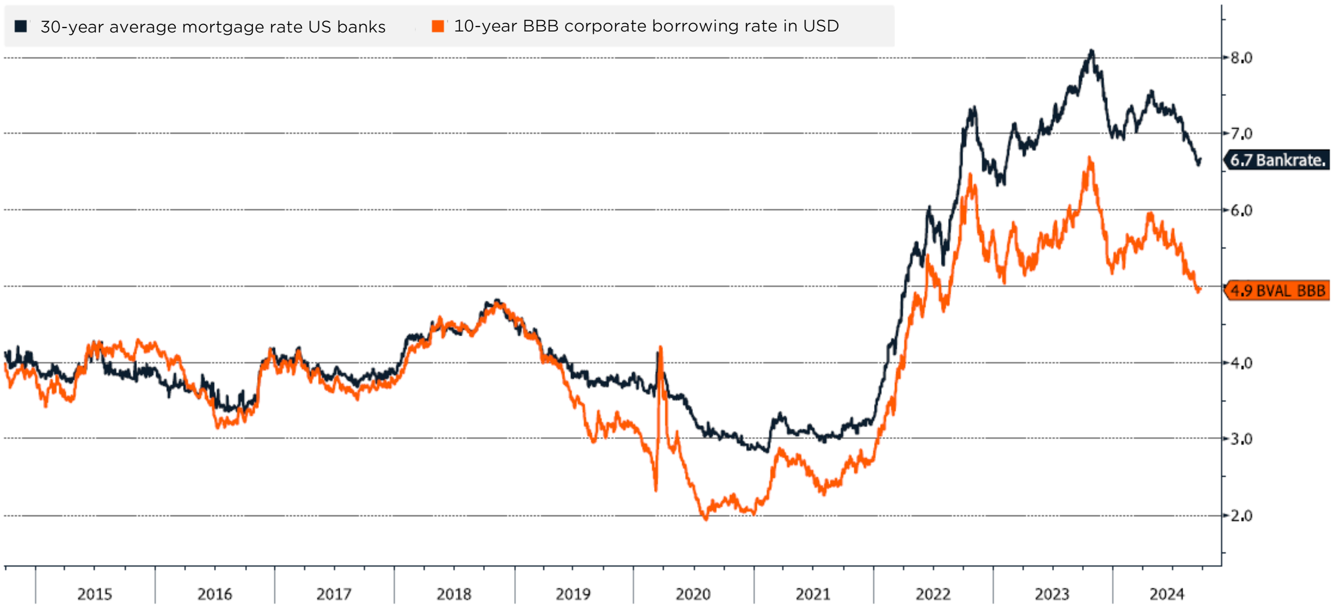
THE FED IS FINALLY CUTTING ITS RATES!

The Fed had been holding out for some months, but it has now done so. It made its first monetary easing in nearly 4 years by lowering the range for its key rates (overnight) from 5.25%-5.50% to 4.75%-5.00%. Like most other developed central banks, it believes that the fight against inflation has been won and that supporting a declining US economy is now the number 1 priority. It is therefore a deluge of rate cuts that we will see in the coming months in developed countries. This is not generally to the displeasure of the markets, but as is often the case in economics, not everyone is in the same boat. ɵOne size fits allœ is not appropriate here.

LOWER SHORT-TERM RATES DO NOT AFFECT EVERYONE TO THE SAME EXTENT

Short-term rates that are now trending downwards are a real relief for all economic players dependent on short-term or variable-rate financing. Households using consumer loans or companies operating around the real estate sector are among these and will be able to benefit from an immediate reduction in their financial expenses.

However, this situation will have only a very moderate effect on households and companies that borrowed during the golden age of central bank rates at 0%. At that time, a 30-year mortgage was trading around 3% in dollars and 2% in euros. Many companies have also been able to raise debt at even much lower rates. As a result, interest rates will have to fall very significantly in order to encourage these economic players to apply for new loans or to engage in a voluntary refinancing operation for existing debt.

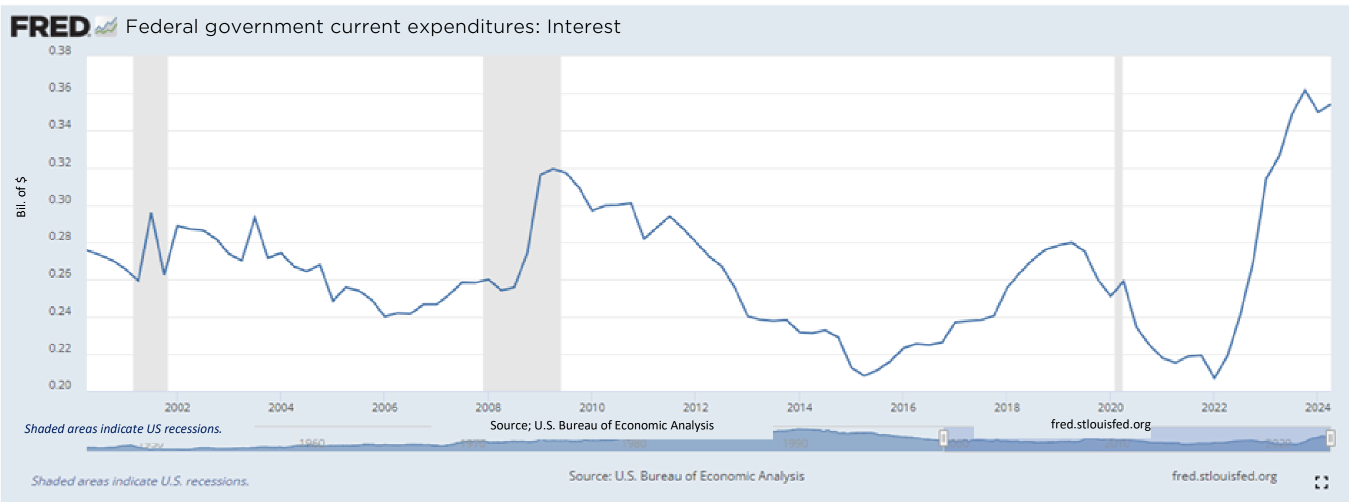


Change in 30-year mortgage rates and average borrowing rates of BBB-rated companies in dollars: more rate cuts will be needed for these players to agree to waive their existing loans and take out new ones.

Source: Bloomberg, Edmond de Rothschild Monaco

THE OTHER UNEXPECTED BENEFICIARY OF THE RATE CUT: THE GOVERNMENT

We regularly discuss with you the fact that the public debt of most developed countries is well above 100% of GDP. The impact of this situation is particularly felt on the level of public finances when it comes to paying interest on the debt to holders of government bonds. When rates were at 0%, there was no particular stress, but with rates at 5% in the United States or around 3% in Europe, the situation changes. In concrete terms, with such a high level of public debt and current interest rates, financial charges often represent the State's largest expenditure budget. In the United States, they represent more than $1,000 billion, or 35% of the annual budget! There is no doubt that a reduction in short-term rates will be particularly appreciated by the Treasury.



Debt interest expense as a percentage of tax collection has increased significantly due to the increase in outstanding debt and interest rates. Financial expenses now account for 35% of government revenues.

Source: Saint Louis FED – Edmond de Rothschild Monaco.

In concrete terms, when the State has to spend, a cash flow is recorded by debiting the government's current account (held at the central bank) and crediting the bank accounts of private sector households and companies.

Thus, while high rates represent a greater financial burden for debtors, they also represent a financial bonus for those with solid financial savings.

Historically, when rates were rising, private players generally suffered. This had the effect of slowing activity, inflation and tax revenues. Conversely, when rates were falling, it stimulated the economy and therefore tax revenues. However, when public debt exceeds 100% of GDP (or 123% for the US), high rates actually translate into more monetary liquidity being transferred from the public sector to the private sector. At the macroeconomic level, they offset the negative effects of high interest rates. Not only do the least indebted households and companies not suffer, but they even benefit from an additional return on their savings. High rates, in this case, tend to stimulate the economic health of well-off households and high-quality companies whose merits we have been touting for many months or even years.

The opposite is just as true: lower short-term interest rates mean less stimulation for these players, who will see their savings pay less.

FALLING SHORT-TERM RATES ARE RARELY BAD NEWS FOR THE MARKETS:

The announcement was expected, but the markets have nevertheless risen since the Fed officially cut its key rates. Historically, the periods following the first rate cuts have been marked in most cases by an increase in the price of most financial assets. We believe 2024 will be no exception.

And for good reason, the monetary liquidity transmitted by the public authorities to the private sector is probably one of the most important factors in the formation of stock and bond prices, far beyond the prospects for profit growth. By spending, the government increases the amount of money available in the private sector that ends up being recycled to existing financial assets by pushing their valuation upwards.

If the last quarter of the year is to be marked by an indecisive US presidential election, the result in terms of the budget deficit should be about the same: it will not go down. Admittedly, Kamala Harris and Donald Trump's economic programmes diverge greatly, but from a fiscal point of view, public spending increases or decreases in taxes have roughly the same effects. The public deficit will create a natural increase in liquidity that will continue to positively influence market prices.

We are mainly talking about the United States because of the importance of dollar liquidity in the global economy, but this phenomenon is not limited to the United States alone. Indeed, the central banks of the European continent (ECB, BOE and SNB) are also embarking on a path of easing interest rates. For its part, China seems to be in an economic impasse characterised by industrial overcapacity that the rest of the world is reluctant to absorb. Monetary stimulus appears to be an obvious solution.

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In our view of the markets, one thing seems to us to be both decisive and positive in the medium/long term: public debt will continue to grow and should lead to sustainable monetary inflation. A structurally growing amount of money in the private sector is a fundamentally conducive environment for holding real assets such as quality stocks (those whose companies have a strong balance sheet and a sustainable competitive advantage) and gold.

Even in the short term, the sensitivity of market prices to liquidity inflows and outflows has increased considerably. Indeed, the 20% drop in the Nikkei this summer, following the (albeit partially expected) decision by the Japanese central bank to raise its key rates by 0.25%, showed just how sensitive the markets were to any move to withdraw monetary liquidity.

At the same time, a cycle of rate cuts has just begun, which is rarely bad news for financial markets. Combined with the increase in monetary liquidity in the private sector, it is a powerful cocktail of boosting equity prices. While the direction seems clear to us, our attention is focused on which players are most likely to see their share price rise. We are about to enter a new phase in which leadership of the equity markets should no longer be the sole preserve of technology stocks. A sector rotation in favour of companies benefiting from the easing of short-term rates is part of a certain logic. As a result, the likelihood of a broader participation by stocks in a movement that we still expect to be bullish is increasing.

This sector rotation has already started this summer. However, if this trend is to continue, and if the group of companies that depend on short-term financing is to take a lasting lead in terms of stock market performance, it will only be possible to do so in the context of a real cycle of falling interest rates. If the Fed were to settle for two or
On the bond side, positioning according to the maturity of the securities is of crucial importance. Long-term bonds performed very well this summer, anticipating the Fed's decisions. They include in their price a whole cycle of rate cuts that leave little room for disappointment. This lack of margin of safety explains our cautious stance on government bonds and helps us favour credit risk over duration risk.

Let's face it; if central banks lower interest rates, it is because they see that certain parts of the economy are suffering and that it is time to ease financial conditions a little. The slowdown in economic growth has negative effects on the financial health of companies and households

three cuts, the market's disappointment would match the "hopes" generated by this announcement of the start of an economic cycle where borrowing is becoming cheaper.

We therefore remain confident in the sustainability of the upward movement. With regard to sector rotation, we are preparing for this without rushing. Leaving quality stocks in favour of indebted companies to follow a short-term trend is not in our philosophy.

(difficulties in obtaining financing, unemployment, etc.). The bond market generally offers a barometer for predicting a less prosperous future via "credit spreads", i.e. the yield spreads between a corporate bond and a government bond with the same maturity. The latter are fairly tight and stable, reflecting investors' lack of perception of significant risk in the economy. This suggests that the last quarter of the year will continue to be favourable for investment in equities and corporate bonds.

The next Summer Olympics in 2028 will be held in Los Angeles. Let's hope that the curse will be lifted by then.

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