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BANQUE PRIVÉE

House View

February 2024

Thoughts of the CEO

"Sometimes the answers are in the details."

This issue of our House View takes a more granular look at why US inflation is not falling faster. While several economies — China, the Euro Area, Canada and Switzerland — already have negative inflation if we use the recent monthly annualised numbers, the US is lagging.

We open the US consumer price index and focus on an item that comprises 34 per cent of the index. It is a category called "shelter". We compare it with the equivalent for the Euro Area, where the weight is much smaller and the methodology different.

We also take a look at the difference in wage growth between the US and the Euro Area. Looking at the details shines a light on how these economies differ from each other, how different their respective inflation index is, and the likelihood that inflation and interest rates could fall faster than currently priced in.

While everyone is struggling to understand the likely speed of the path of inflation back to 2 per cent, not least the central banks themselves, it is often these outlier events that cause us to take a deeper look into the underlying drivers.

We are mindful of the scenario that we might see a rapid fall in inflation in the second half of this year, but that we may then face a return of a more persistent type of inflation driven by a range of well-known factors (demographics, costlier supply chains). There is also the other new factor: AI. If AI means that the world is going to become a lot more productive, does that then not mean disinflation and even deflation? And if so, does that happen rapidly over a few years, say, or does it happen over a period of decades, similar to the introduction of electricity? One thing appears clear, we are entering a new world.

Another topic where we go into more detail is the disconnect between the 5 per cent growth rate of the world's second largest economy and the 7 per cent decline of its stock market in January 2024, on top of a poor 2023. Also, how does 5 per cent growth in China equate with a falling global commodity price index?

While Chinese equities suffered in January, Japan delivered returns of 7.6 per cent (the Nikkei 225 Index). Japan still remains attractive in our view. In this House View, we look more closely at some of the key drivers.

The backdrop that keeps intervening into our news and assessments is politics. There are lots of general elections scheduled across the globe this year. There are also many geopolitical influences. The disruption of oil supply routes could immediately change the markets' assessments of inflation, growth and rates.

Against that background, it is worth also considering where the safer places are to invest in.

Yours sincerely,

Karam Hinduja

Investment Positioning

A slowing global economy is set to put pressure on corporate earnings in a market that seems to have recently discounted much of the expected monetary pivoting during 2024. We expect that the lagged effects of higher rates will continue to feed through the US economy in the quarters ahead. Only a significant and rapid reduction in interest rates, triggered by falling inflation rather than a deteriorating economy, could spur a new rally in equities, which already trade at demanding multiples. We do not currently see firm reasons to change our cautious stance on equities.

Opening the box on the US inflation index

In this issue of the House View, we have taken a deeper dive into a component in the US consumer price inflation index that has lagged the speed with which headline inflation has declined.

While markets have been focused on how soon inflation returns to its 2 per cent target in year-on-year terms, several economies are already well below that number in monthly annualised terms. In fact, some are even experiencing a mild deflation. China and the Euro Area are running an inflation rate of -2.4 per cent on this measure, and Canada and Switzerland -1.2 per cent (Fig. 1).

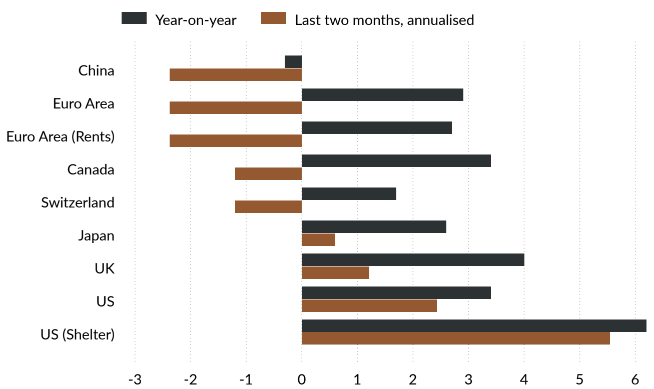
When low or negative monthly rates are sustained for a while, then it is only a matter of time before the year-on-year rate plunges. Across all the economies shown in the chart below, the monthly annualised inflation rate for the last two months is lower than the year-on-year number. This tells us that, absent new price shocks, in particular from energy prices, near-term inflation is likely heading much lower.

The US stands out, though, at the high end of our selected economies. Accordingly, at its meeting at the end of January, the Federal Reserve left its policy rate unchanged at 5.25 per cent to 5.5 per cent. This decision was accompanied by the following sentence: "The Committee does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2 per cent."

The price of "shelter"

One statistical factor still holding up US inflation relative to Europe is the US item called "shelter", which has a

Fig. 1: Consumer price inflation, percentage change



The chart shows the monthly annualised consumer price inflation for November and December 2023 (the most recent numbers available) and the year-on-year rate. It also shows the divergence between the US "shelter" number and the Euro Area equivalent called "rent".

SOURCE: NATIONAL STATISTICS, LSEG

weighting of over 34 per cent in the US consumer price index, compared to less than 6 per cent for the eurozone equivalent called "rent". We indicate both in Figure 1.

While home ownership is similar in both the US and the eurozone (around 65 per cent), a house is not considered a "consumption" item that enters the consumer price index but is classified as "investment" or "capital".

The Europeans and the Americans deal with this tricky classification differently. Both include actual rent (a 6 per cent weighting in the eurozone inflation index and a 7.5 per cent weighting in the US index), but the US then uses an expanded definition of "shelter" that includes a theoretical "owner's equivalent rent". The US authorities obtain this theoretical number from a survey, in which they ask the owners living in their primary residence this question: "If someone were to rent your home today, how much do you think it would rent for monthly, unfurnished and without utilities?".

Unlike in Europe, where rent control is more widespread, which is keeping European rent inflation lower, US homeowners have been providing big free market theoretical rental numbers in replies to those surveys. There is some suspicion that there may be a problem with those US numbers.

An alternative US rental index, the "Zillow Observed Rent Index", tracks rental asking prices. As might be expected, it is more volatile than the government survey. It showed US rental inflation in December 2023 at 3.3 per cent, compared to the official US government number of 6.2 per cent. This means that, had the Zillow number been used instead of the official "shelter" number, the US year-on-year headline inflation in December 2023 would have been 2.4 per cent instead of 3.4 per cent.

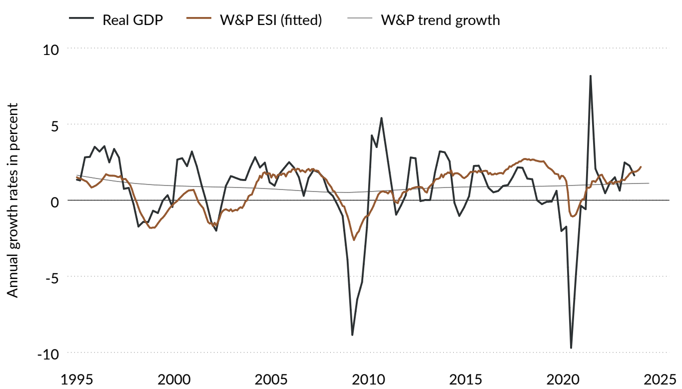
Accordingly, the "shelter" item is currently a significant statistical factor. The government survey number peaked in March 2023 at just above 8 per cent, and is heading lower, but very slowly (by -0.2 percentage points per month from March to December 2023). At that pace, we could be at around 3.5 per cent by December 2024.

Accordingly, we need to be aware that a key component to relative US price inflation stickiness relative to Europe is linked to a survey on a theoretical rental number.

China and the global goods recession

China sentiment indices have remained at unsatisfactory levels in recent months. The anecdotal evidence from the property market is worrying. Transaction prices for property in Shanghai are said to have fallen by 10 to 30 per cent since their peak in 2021. And foreign trade is also disappointing, with a level that is almost twenty per cent below the values of 2022. This is a clear indication that we are still in a global goods recession. This may also partially explain the weakness in commodity prices (the Bloomberg Commodity Index is down 10.4 per cent from January 2023 to January 2024).

Fig. 2: Japan's economy is growing above trend again



The chart shows Japan's trend growth rate (i.e. its potential), which we estimate at around 1.1 per cent, compared to the most recent real GDP number and the implied near-term growth number derived from high-frequency data (W&P ESI fitted).

SOURCE: LSEG, WELLERSHOFF & PARTNERS

As shown in Fig. 1, China is also the only country in our selection whose economy is in deflation both on a year-on-year basis and on a two-monthly annualised basis (i.e. pricing power has been poor and getting poorer). As long as the economy remains weak, the overall rate of inflation could slip further. So far, monetary policy has focused on weakening the yuan in order to mitigate the effects of the goods recession on industry.

In his speech in Davos in January, Chinese Premier Li Qiang made the point that "we did not resort to massive stimulus. We did not seek short-term growth" and that the focus was on "new growth drivers".

The Chinese stock market has not reacted well to the analysis or the response. The Shanghai Composite declined by 6.9 per cent in January 2024, a continuation of a deteriorating trend in 2023 (-13.3 per cent from January 2023 to January 2024).

One oft-cited factor is the impact on listed equities of a wide range of new regulations that have impacted profitability in various sectors, including in Tech, Education and Finance. Another factor is that weakening property prices are making consumers poorer and more cautious.

There is, therefore, a disconnect between the Chinese real GDP growth numbers, around 5 per cent in 2023, and real estate and stock market prices in the world's second-largest economy in nominal US dollar terms.

Japan's expansionary monetary policy: expecting an exit in 2024

The heavily undervalued Japanese yen (please see the deviation from purchasing power against the US dollar in the chart on page 7), steadily lost value against the US dollar from December 2020 to end of January 2024. The currency has had temporary bouts of strength, such as in December 2023, when it appreciated moderately against most G10 currencies. This was probably also linked to statements by the Bank of Japan (BoJ), which indicated that the authorities were at least thinking about abandoning the ultra-expansionary monetary policy. On 1 January 2024, an earthquake and tsunami caused extensive damage on the Noto Peninsula. The BoJ reaffirmed that it would fully support the financial system after the disaster, which triggered a debate about the possibility of a further delay in the exit from the expansionary monetary policy.

With the economy growing above trend (Fig. 2), monetary policy loose, the currency cheap and inflation expected to return to target this year (please see the table on page 7), at some point the conditions would be met for tighter monetary policy and a stronger exchange rate. This would impact Japanese companies differently. Yet, as we saw in the case of the United States last year, a stock market can do well even if interest rates rise and the currency is strong. A trajectory to some kind of "normalisation" (away from negative interest rates and ceilings on 10-year government bond yields) would be a positive development, in our view.

Why we still like Japan equities?

Despite the remarkable performance of Japanese equities in 2023 (the Topix Index ended the year with a 23 per cent return), we believe that the prevailing macro environment will continue supporting risk assets in Japan. However, the market will remain susceptible to how the US economic slowdown unfolds and how the Fed reacts to these events. The latter could have impacts on Japanese exporters.

In general, the domestic economy is expected to remain relatively stable and corporates that have changed their pricing strategy may continue to see margin expansion as imported inflation gradually subsides. Wage hikes are expected in 2024 on the back of a shortage of labour that will hence underpin household consumption, which in turn could eventually accelerate a shift in monetary policy. Additional shocks from energy prices driven by an escalation of geopolitical tensions in Israel remain a potential risk factor that deserve close monitoring.

At the corporate level, the stock market reform will continue paying off, we believe. The stimulus to improve corporate governance will continue to lead to value creation measures. The sustained effort of companies trading below book value to rectify their situation is expected to accelerate. Companies will continue working to unwind crossed shareholdings, restructuring their business portfolios and enhancing their return on capital employed. This is simply good news for stakeholders and has constituted a game changer for Japanese equities. The close monitoring from the Tokyo Stock Exchange will lead to further acceleration in corporate governance.

In addition, the Japanese market offers a strong earnings momentum with increased visibility compared to the main developed markets. Corporate earnings are expected to grow by 10 per cent in 2024, following 2023's 12 per cent. Growth this year is expected to be led by sectors that are recovering from cyclical downturns such as electrical appliances, materials, chemicals, machinery, as well as information and communication. Value opportunities are abundant in construction companies, banks and utilities.

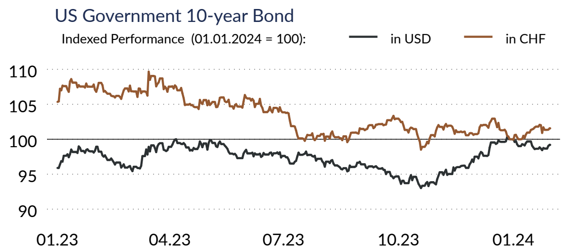
Besides, total shareholder return will receive a boost in the form of additional dividends and significant buy-back programs.

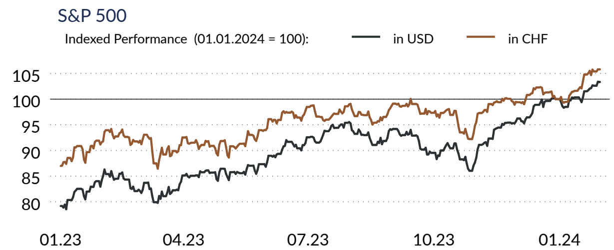
Macroeconomic estimates (in %)

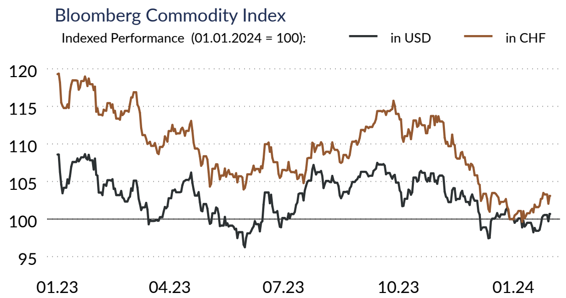
	GDP Growth			Inflation		Interest Rates	Money Growth M1
	Trend	2024E	2025E	2024E	2025E	Q1 2024	y/y 01/2024
USA	1.6	1.2	1.6	3.2	2.2	5.50	–8.8
Eurozone	1.1	0.6	1.4	3.2	2.4	4.00	–8.3
UK	1.7	0.8	1.5	3.8	3.0	5.25	–6.5
Switzerland	1.3	0.8	1.6	2.0	1.5	1.75	–17.1
Japan	1.1	1.0	1.2	2.0	1.5	–0.10	3.8
China	4.5	4.3	4.5	1.0	1.5	4.35	1.3
Brazil	1.4	1.8	1.8	4.0	4.0	11.75	0.7
India	5.0	6.3	5.5	4.5	4.5	6.50	7.9
Russia	1.0	1.0	1.0	5.0	4.0	16.00	15.4
World	3.0	2.7	3.1	4.6	3.8	—	—

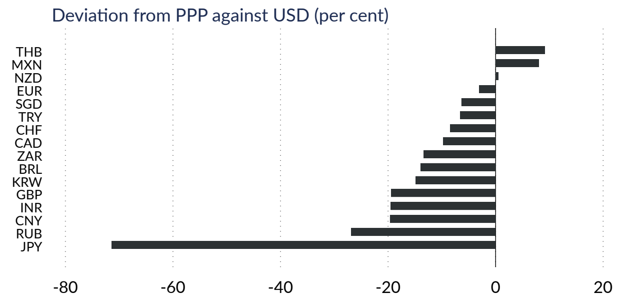
SOURCE: LSEG, WELLERSHOFF & PARTNERS

Financial Markets









SOURCE: LSEG, WELLERSHOFF & PARTNERS

Global Asset Allocation Preferences – February 2024

Asset Class	View	Constituents	Most Preferred	Least Preferred	Commentary
Fixed Income	++	Segments	US Treasuries and developed market investment-grade credit.	Convertibles, High Yield, Emerging Market debt.	Lower economic growth in 2024, falling inflation, signs of a cooling labour market and a likely pivoting in the Fed and ECB policies add atrractiveness to core fixed income. We favour US and German sovereigns as we see demand for safe-haven assets rising on lower growth/recession context. Though spreads in both the US and Europe look low, we prefer IG credit in developed markets over high-yield, preferably in non-cyclical sectors. Current IG yields look quite compelling and provide a valuation cushion in a scenario of rising default rates.
		Duration	Medium-term.		

VIEW: ++ VERY ATTRACTIVE + ATTRACTIVE = NEUTRAL – UNATTRACTIVE –– VERY UNATTRACTIVE

Global Asset Allocation Preferences – continued

Asset Class	View	Constituents	Most Preferred	Least Preferred	Commentary
Equities	–	Markets	US and Japan. Selective in Europe. India long-term	Latin America	Despite the uncertain cyclical positioning of the global economy, the US growth outlook for 2024 has recently improved, with the soft landing scenario gaining momentum. However, the outlook on corporate earnings remains unsteady, adding downside risk to the asset class. We see pressure from slowing inflation, higher financial costs and continuing wage growth as drivers for corporate margin compression this year. We then prefer less volatile stocks and defensives to cyclicals. Broadly, investors need to reinforce the bottom-up approach and look for high-quality companies.
		Styles/Sectors	High-quality. Value. Dividend growers. Defensive sectors.	Cyclicals. Small caps	Europe: the macro backdrop deteriorates and is decoupling from the US. Recession looms in 1H 2024. Leading indicators remain in contraction territory but are gradually improving. Earnings momentum does not look attractive. Valuations are cheap, but it is probably too soon to play a recovery that depends much on the global cycle. Historically low equity valuations in China and recent stimulus measures announced by the government should help investors regain confidence in the market. We favour India on more visibility in corporate earnings and the economic cycle.

VIEW: ++ VERY ATTRACTIVE + ATTRACTIVE = NEUTRAL – UNATTRACTIVE –– VERY UNATTRACTIVE

Global Asset Allocation Preferences – continued

Asset Class	View	Constituents	Most Preferred	Least Preferred	Commentary
Alter-natives	+		Selected direct real estate. Gold.	REITs	The resumption of the positive correlation between equities and fixed income support our overweight in Alternatives. Gold should benefit from an eventual rate cut by the Fed later in the year and by central banks' buying activity. High inflation, the energy transition and growing digitization of the economy remain valid arguments to favour infrastructure as an alternative. Writedowns and defaults are still a threat for real estate. However, a normalization of rates towards 2H 2024 might start adding some comfort to public REITs.
Cash	+				The direction of the global economy still shows a high degree of uncertainty. With Cash offering > 5.0% yield in USD and rates staying steady in the short term, we thus maintain an Overweight opinion on the asset class.

VIEW: ++ VERY ATTRACTIVE + ATTRACTIVE = NEUTRAL – UNATTRACTIVE –– VERY UNATTRACTIVE

Figure of the Month

–0.1

This is the interest rate set by the Bank of Japan for its monetary policy. Last year, it was thought that Japan would exit this ultra-loose monetary policy soon, but that has not yet materialised. A loose monetary policy has contributed to the Japanese yen being highly undervalued (please see our valuation calculation on page 7) and has supported the equity market. We expect to see an exit from the Bank of Japan's negative interest rates in 2024.

S. P. Hinduja Banque Privée – A family-owned Swiss Bank with Indian roots.

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Founded in Geneva in 1994 by Srichand Parmanand Hinduja with a vision to provide clients with a bridge between East and West, our institution remains the only Indian-owned Swiss bank in history. With an active presence in Switzerland, India, UAE and the UK, S.P. Hinduja Banque Privée offers its clients the reliability of Swiss regulatory oversight, while providing specialized access to high-growth markets.

We are a private bank with an entrepreneurial spirit, embracing collective action and building creative solutions that advance the world, economically and socially.

The future of banking is emerging at the intersection of profit and purpose.

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