

The Way We See It

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For how much longer will bond vigilantes box equities in ?

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A brief update report which serves to review the recent market development and to offer our outlook for the rest of the year and beyond.

Review of Developments - Global Economies

On the growth side, major OECD countries recovered modestly in Q2 and in early Q3, based on preliminary and partial data available in a number of countries.

On the strong side, preliminary guesstimates of Q3 GDP in the U.S. continue to point to a robust quarter. The latter is boosted by strong government-sponsored capital expenditure spending, a recovery in consumer durables (housing, cars) and a confident household and business sectors.

On the opposite end of the growth spectrum, early partial indicators in the Eurozone still pointed to a sluggish trend. In the case of China, because of the government's relatively feeble attempt to boost its domestic economy, partial indicators continued to reveal continuing weakness. Debt issues relating to the property sector, continuing fall in exports and a lack of confidence in both household and business surveys continued to depress the domestic recovery.

On the inflation front, since August to date, in most developed economies, the favourable headline

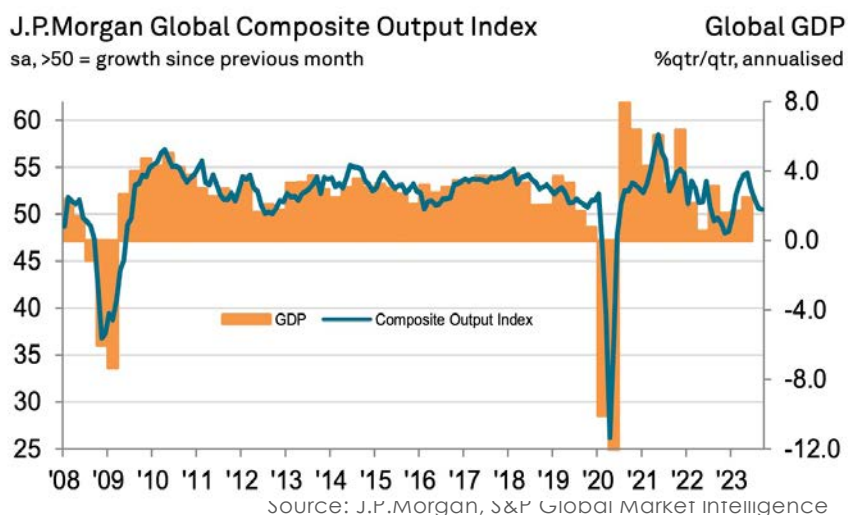
trend was reversed by the bounce in energy prices. Furthermore, core inflation indicators, while decelerating in the last few months (i.e. the 3-month annualised core Personal Consumption Expenditure Deflator in the U.S. has fallen from 6% a year ago to 2% currently), remain elevated. The latter is caused by a number of structural factors including rising wages in low-skilled services, lower net immigration, green energy, manufacturing re-shoring, and so on.

The key message from the latest Fed's FOMC meeting emphasised the need to keep rates high for longer, as the road to achieving an annual 2% core inflation rate remains uncertain. In the month of September, most central banks remain on hold.

Finally, global geopolitical risks remain high: Russia and Ukraine, Gaza and Israel, plus geopolitical and trade tensions beyond semiconductor chips between the US and its partners, against China.

The need to keep rates high for longer remains.

J.P.Morgan Global Composite PMI™



- Global Markets

Following a strong rally in equities in the month, quarter and year-to-date periods ending July, the months of August and September recorded a "long-awaited" correction in equities and all risk assets. This

was mainly caused by the continuing hawkish messaging by the Fed and other G7 central banks, rising long bond yields and an overvalued IT sector. Cash, as a result, was the outstanding winner.

Within the global equity universe, the Chinese and the rest of the Emerging Markets bloc also performed poorly. Investors were disappointed with the continuing poor growth in exports as well as domestic demand, and the feeble effort by the government to reflate.

Interestingly, the dominant seller of stocks in the month, again, appeared to continue to have come from fundamental investors. In September, the former group's selling forced the Quant- / Algos-driven funds to sell as well, as prices fell and volatility rose. High interest rates continued to attract the attention of asset allocators.

Quants and Algos joined the selling spree as equity prices fell and volatility rose.

Near-term performance of various asset classes

as at 29/9/2023

Asset Class Index	US Equities MSCI USA	Global Equities MSCI World	GEM Equities MSCI EM
1 month	-4.69%	-4.28%	-2.57%
3 months	-3.07%	-3.36%	-2.79%
YTD	13.53%	11.55%	2.16%
FY 2022	-19.46%	-17.73%	-19.74%

Asset Class Index	US Corporate Bloomberg US Corporate	US Treasury Bloomberg US Treasury	US Aggregate Bloomberg US Agg
1 month	-2.67%	-2.21%	-2.54%
3 months	-3.09%	-3.06%	-3.23%
YTD	0.02%	-1.52%	-1.21%
FY 2022	-15.76%	-12.46%	-13.01%

Asset Class Index	Global Govt Bonds Bloomberg Global TSY	Global Aggregate Bloomberg Global Agg	Global Commodities CBR
1 month	-3.17%	-2.92%	0.93%
3 months	-4.17%	-3.59%	8.60%
YTD	-3.63%	-2.21%	2.44%
FY 2022	-17.47%	-16.25%	19.53%

Asset Class Index	Asia ex Japan Equities MSCI AC AxJ	China Offshore MSCI China	China A MSCI China A Onshore
1 month	-2.65%	-2.74%	-1.82%
3 months	-3.22%	-1.83%	-4.54%
YTD	-0.13%	-7.13%	-8.64%
FY 2022	-19.35%	-21.80%	-27.09%

Source: GOJI, MSCI, Bloomberg

Similar to the trends observed last month, in September, the US and global bond markets

continued to trade poorly. Cash outperformed bonds

continued to trade poorly. Cash outperformed bonds in all periods including the month, quarter and year to date to the end of September. The government bond market's weakness can be explained by the fact that there has been a large amount of new supply of US bonds hitting the market, particularly at a time when the Fed continued to withdraw liquidity via quantitative tightening and higher cash rates (*more on Bonds in our Special Topic section at the end of the report*). In addition, while there has been some improvement in the headline inflation rate, central banks' number one priority is to continue to maintain a tight monetary policy to fight against a stubbornly high core inflation rate.

The US Dollar continued to rebound modestly in September, helped by the hawkishness of the Fed, and the lack of positive economic surprises from Europe and China.

The Commodities complex rose a little, helped by a rebound in energy and hard coking coal/iron prices. The later reflected the moderately more positive sentiment towards China growth.

In terms of equities investment flows and positioning, both fundamental and quantitatively-driven funds now have turned from overweight to slightly underweight equities, relative to their historical norm.

Cash outperformed bonds; Govies weakness continued.

Consolidated Equity Positioning



Source: Deutsche Bank Asset Allocation

Discretionary vs Systematic Equity Positioning - Systematics Buying vs Discretionary Selling



Source: Deutsche Bank Asset Allocation

Traders and investors appear to acknowledge that August and September have tended to be two seasonally negative months for markets. Hence the relatively thinner trading liquidity, which, as a result, exacerbated the intra-day and intra-week volatility of stocks and sectors.

Lastly, while the consensus remains hopeful to see the resumption of the H1 bull market in the December quarter, they currently seem less sanguine. The Fed's hawkishness has pushed the whole yield curve up, which, in turn, has forced investors to reduce equities versus cash and bonds.

Market Outlook - Global Economy

While there are both positive and negative factors operating in the US and the world economy, the potential growth positives are likely to continue to favour the U.S. over the rest of the world, as discussed previously.

Europe is likely to be burdened by the lack of growth initiatives and the high interest rate regime. Thanks to its government's moderately easier policies, the Chinese economy may have bottomed, but the strength of its economic recovery is still clouded in

Consensus remains hopeful to see bull market in Q4; chance is diminishing.

uncertainty. The sputtering growth engine of China and the domestic-focused nature of the US economy are unlikely to help the rest of the world.

In brief, the US and world economy are expected to continue to grow, but at a sub-par rate. Having said that, we continue to attach a small probability to a mild US recession, possibly occurring in 2024. We are still somewhat concerned that, after a decade of almost zero interest rates and trillions of QE and fiscal pumping, the abrupt reversal of these super-easy monetary and fiscal policies has and is likely to continue to cause unexpected financial crises and/or recessionary conditions. Net, net, the world economy, in our opinion, remains fragile (financial accidents have and can continue to happen!).

The Way We See It

- Global Markets and Investment Thematics

The above economic, monetary, and geopolitically unbalanced backdrop is expected to prevail in the remaining of the year.

In the short-term, we continue to think that it would be sensible for long term investors to continue to adopt a neutral-risk strategy, particularly after a big rally in equities in H1. This translates into a strong focus on quality and lowly-gearred assets that can deliver predictable cash flows. In addition, until the US banking and commercial property sectors are functioning healthily and that the Fed truly pivots from doubly tight (high cash rates and QT) to ease, investors could consider holding a mild overweighting in US-dollar-denominated Treasuries and Investment Grade corporate bonds.

In terms of geographical diversification, it appears that it may pay to be neutral in the US versus other global equities. This is based on the differing growth, liquidity and valuation trends across the globe, which currently favour the rest of the world over the US.

GOJI's view remains - sensible to adopt a neutral-risk & quality-focused strategy.

Short-term Technical Analysis

We wish to continue to share a technical chart of the leading risk index in the world, the US-based S&P 500 stocks index. It shows that the index has been gradually rising since October 2022, within a volatile upward-trending trading range.

Importantly, the rising 50-day moving average has crossed the rising 200-day counterpart in Q1 of this year, an event which is known as a 'Golden Cross'. The latter is a positive signal (as long as they trend upwardly), suggesting higher prices ahead on a medium-term basis.

S&P 500 Stock Price Index



Source: MarketWatch.com

In the month of May, the S&P 500 Index crossed above the significant 4200 overhead resistance level, consistent with its Golden Cross signal. The months of June and July saw a somewhat surprising acceleration of the bull trend, which took the Index by a further 10% or so. However, this has now all changed in the period since the end of July to date. The S&P 500 has almost given up all of the 10% gain in the August-early October period.

We remain skeptical in sustainable rally in US; market appears to be excessively bullish.

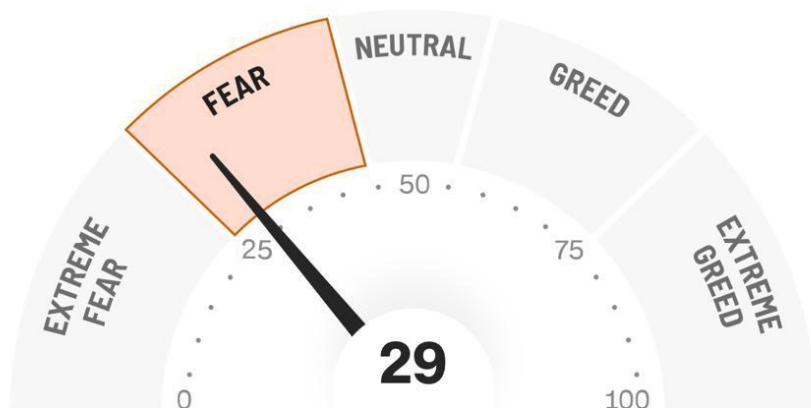
As discussed in our last two reports, we remain somewhat skeptical that the equity rally in H1 can be maintained in H2. In other words, while the majority of analysts continued to predict new historical highs for US equities by year end, it has been our view that the former appear excessively bullish.

Having said that, given that investors' sentiment has turned increasingly more bearish and that equity positioning has gone from overweight to slightly underweight, we believe that, for investors who can trade, they can look for entry points to buy their preferred stocks, bonds and/or currencies.

Entry points emerge in the short term to buy in all traditional asset classes.

Fear & Greed Index

- What emotion is driving the market now?



Source: CNN Business

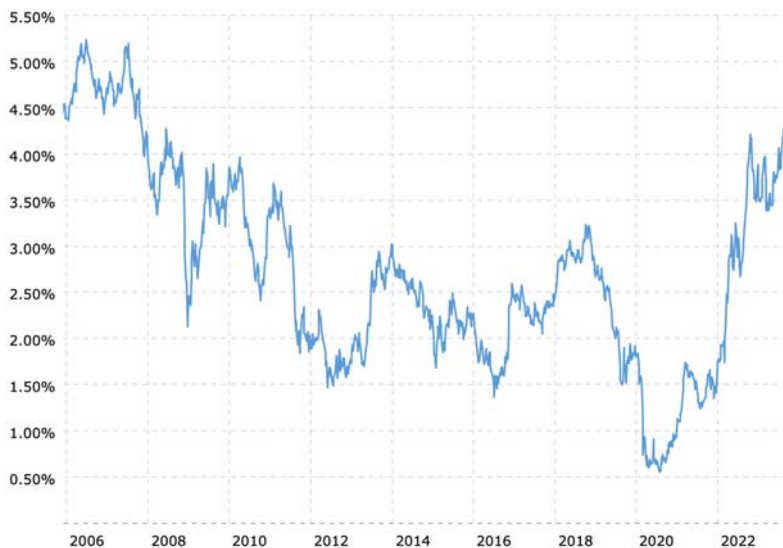
To summarise, it remains our strong belief that a sustainable bull market in equities and corporate bonds will return at some stage, but it would only occur when valuations fall further to reflect the US and global sluggish growth trend, and, more importantly, when the US Fed and other major central banks switch from the current tightening to an easing mode.

In the meantime, due to continuing macroeconomic uncertainties in the global economy, markets are likely to remain volatile. Consequently, in our opinion, a neutral-risk and quality-focused investment strategy should remain the foundation of risk-averse investors.

Post-Script

Significance of high US bond rates and Impact on US stocks and other global risk assets

TNX since 2006



Source: Microtrends

On a fundamental basis, at any yield level of 4.50% p.a. and above, US 10-year government bonds, in our opinion, offer very attractive value. This is based on both the recent and future inflationary trends: the last 6-month annualised rate of inflation (core personal consumption expenditure index, a preferred inflation gauge used and monitored by the Fed) has steadily been falling from the peak of close to 5% pa to 2.9%. The latest 3-month annualised rate of increase of this key inflation measure is falling even more dramatically, to a low of 2%, the Fed's ultimate inflation target. Based on the sluggish growth prospects in the U.S. and around the world, the outlook of this inflation indicator also suggests a rate between 1.75 to 3% pa.

Given the above fundamental backdrop, one can be forgiven for thinking that the US bond market should be quite bullish, and that the U.S. 10-year bond yield should have fallen to 4-4.25% pa. But the reality is very different.

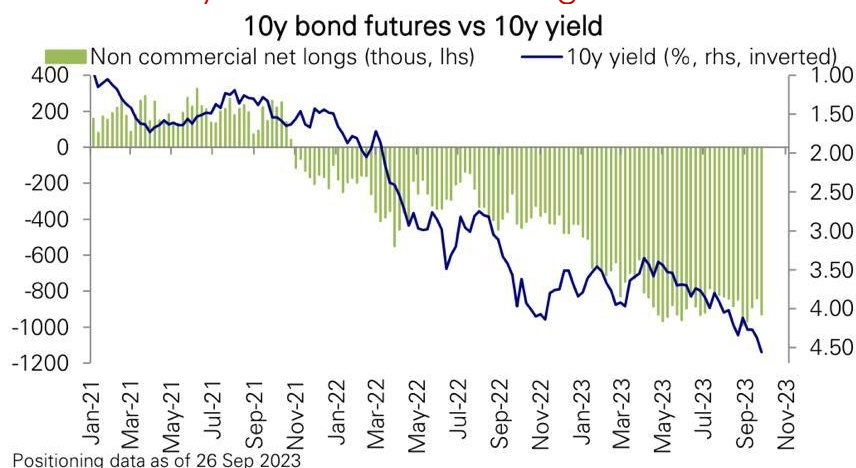
10-Year Treasury Yield hits highest level since 2007.

Our explanation of the reality versus fundamental is as follows - we believe that there have been a few clear adverse technical / sentiment factors pushing bond yields up:

a. Excessive Supply: there has been and will be a massive amount of new supply of government bonds in the Q3 and soon in the Q4 quarters. Approximately \$US 1.8 trillions of new bonds are issued by the U.S. Treasury. That is about \$US 300 billion of new bonds per month. In addition, the Fed is not rolling over its expired government bond holdings, which thus results in a further \$80-90 billion of bonds issued by the Treasury to repay the Fed. Adding the two together, the total amount of new bonds issued comes close to \$US 400 billion each month. Talking about excess supply or indigestion!

To make a bad situation worse, hedge funds and traders were reported in the social financial media to short something close to \$US 600 billion of bonds. That's equivalent to added new supply of bonds.

10Y Treasury Notes Future Positioning



Source: CFTC, Haver, Deutsche Bank Asset Allocation

b. Fed's Hawkishness : the Fed's chairman, following the September FOMC meeting, warned that the Fed will continue to maintain a tight monetary policy for longer (i.e. until the annual YoY core inflation rate falls to 2%), and, depending on economic data, leave the door open for further rate hikes.

- c. *“Why buy volatile bonds at 4.80% pa when I can get a safe 5.50% on cash?”* - Another reason why bond managers and other investors are not jumping into bonds at these attractive levels is because they are currently earning a very safe and steady return of 5.50% p.a. on the cash deposit and short-dated Treasury Bills. Hence, why would they take the risk in buying long-dated bonds, when the latter's price trend has been moving in tandem with that of stocks ?

In brief, while we think that long-dated US Treasuries make fundamental sense for a long-term investor, it is rather challenging to think of a circuit breaker to unlock that value in the short-term. A strategy involving a gradual accumulation of quality long-dated US bonds seems to make sense, particularly while there's so much pessimism in this asset class.

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