Lotos Asset Management

Quarterly Investment View

Lotos
Asset Management

Confidential

October 2023

Does the sudden change in yield curve herald an imminent US recession?

After the main focus has been on inflation for a long time, data-dependent central bank policies led to sharp market movements following the release of economic figures. This was particular true for the largest bond market in the world – the US Treasuries.

Just when the opinion prevailed that a soft landing was very likely, the yield curve of the Treasuries tells us otherwise: a recession may be imminent.

A normal yield curve offers the more yield the longer an investment because investors normally demand a higher compensation for the risk that a longer investment entails. In the past 15 months, however, the US yield curve has been inverted. The beige curve - reflecting the yield curve in March 2023 - shows that an investment for 6 months has yielded over 5%, yet all the longer investments returned much less. Historically, such an inverted yield curve is one of the best recession indicators that exists. It becomes really interesting, when the curve starts to de-invert. Exactly this is now occurring. The actual yield curve shown in green still offers the highest return of over 5.5% for 6 months, but the lowest yield is seen at 5 years. From there yields rise again.

The current de-inversion is even more interesting as it is very seldom. Normally, yield curves normalize with the shorter-term interest rates falling as investors assume, central banks will cut rates. Currently, however, the longer-term bonds are falling. In the rare instances this happened, a recession followed soon.

One could argue that bond yields are currently influenced by the Federal Reserve's Quantitative Tightening and an increase in bond supply due to the rising deficit. Yield curve positioning and movements could therefore have lost their significance.

Yet a potential recession triggered by too sharp increases in Fed fund rates have already been our main concern recently. It caused our reduction in equity positioning in mid-July. The actual moves in the bond market add to our worries all the more. Let's therefore analyze some economic data.

Source: US Treasury

Curve Details: The curve is comprised of US dollar-denominated US Treasury active securities. The 1-month, 3-month, 6-month and 1-year maturities are the most recently auctioned 4-week, 8-week, 13-week, 26-week, and 1-year US Treasury bills. The 2-year, 3-year, 5-year, 7-year, 10-year and 20-year maturities are the most recently auctioned US Treasury notes. The 30-year maturity is the most recently auctioned 30-year US Treasury bond. The curve is updated on each auction day with an effective date of the next market day.

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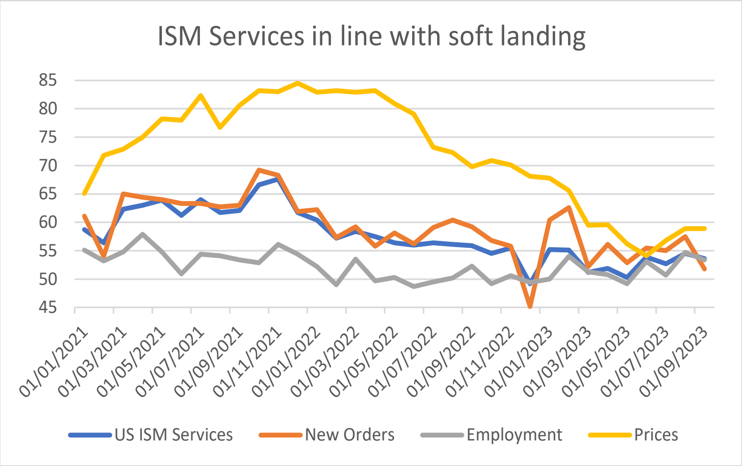
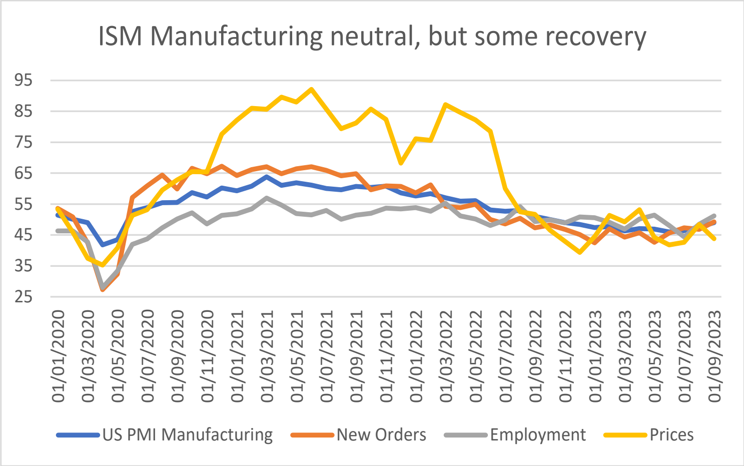
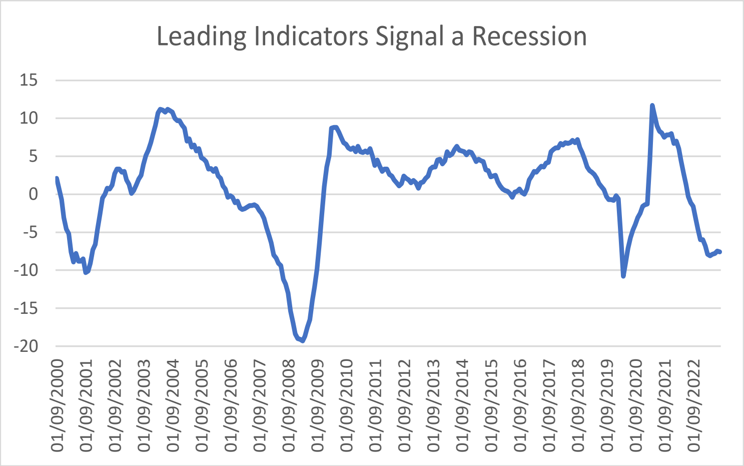


Source: US Institute for Supply Management



Source: US Institute for Supply Management



Source: Conference Board

The ISM Services index, which represents approximately 90% of the economy, experienced an attractive economic activity over summer. The employment situation is still very competitive according to the PMI chair. Right now, the ISM is in line with a soft landing scenario. New orders have, however, clearly decelerated but are not yet in contraction territory.

The PMI manufacturing has been in a contraction for nearly a year, yet the pace of deterioration seems easing. Companies make progress in trimming inventories. On the negative side, the order backlog fell clearly in negative territory.

The Leading Indicator gauge includes economic variables that tend to move before changes in the overall economy. These indicators give a sense of the future state of an economy. The sharp decline in the curve would suggest an imminent recession.

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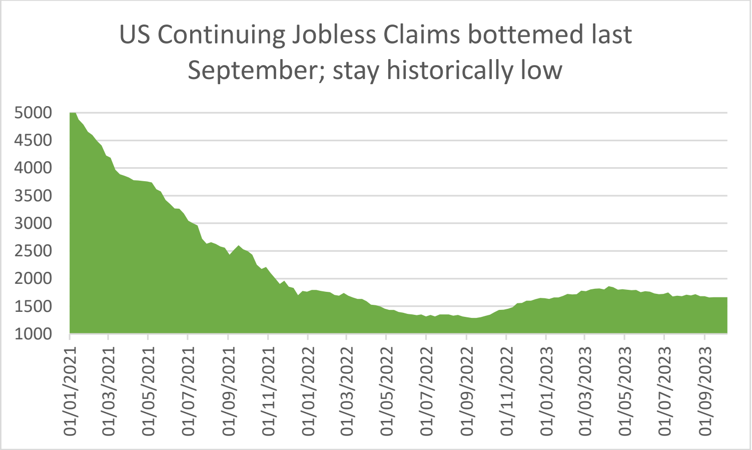
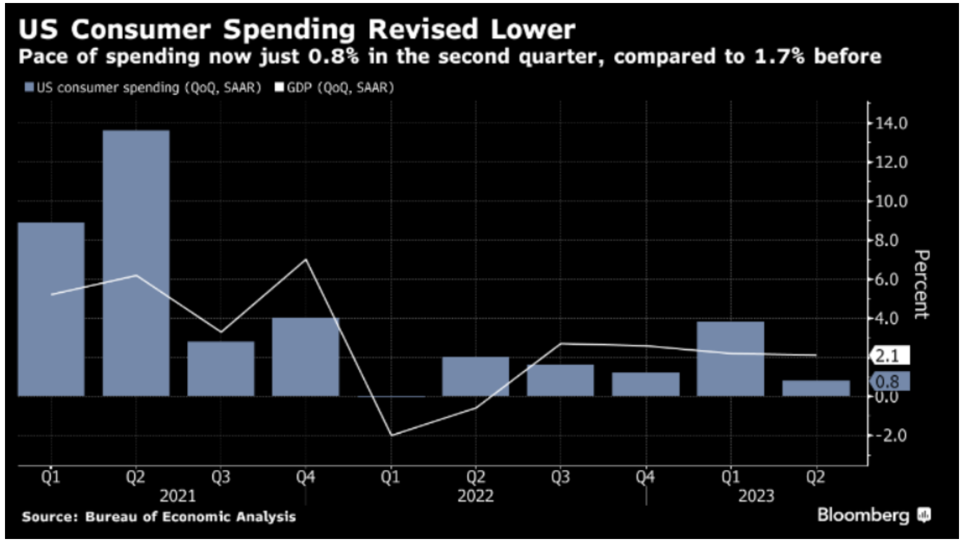
As consumption represents roughly 68% of the US economy, the state of the consumer is of particular interest. The sturdy labor market seemingly was the pilar of the economy. Interestingly, 2Q consumer spending was just half of the original estimate (picture below left) and hence marked the weakest advance in over a year. Such a significant change in assessment is quite rare.

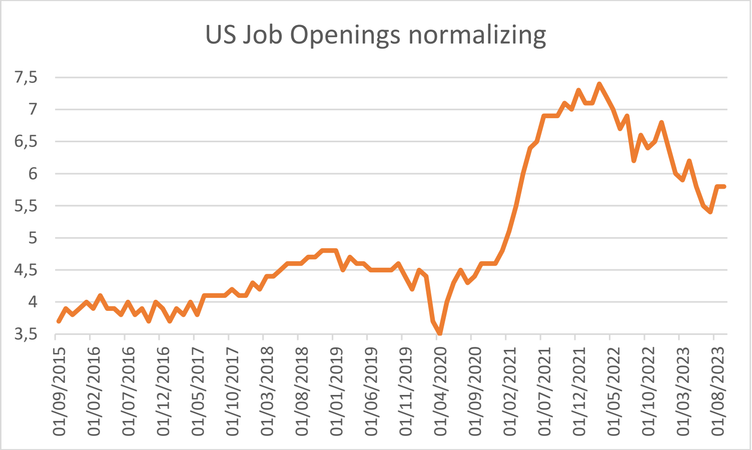
Yet, the employment component in both the previously shown ISM Services and Manufacturing (page 3) show positive trends. Also, the Jobless Claims point to a still solid labor market (picture top right).

Job openings (picture bottom right) seem to have normalized after the pandemic spikes and returned to trend (job openings tend to trend higher over time).



Source: US Department of Labor





Source: US Bureau of Labor Statistics.

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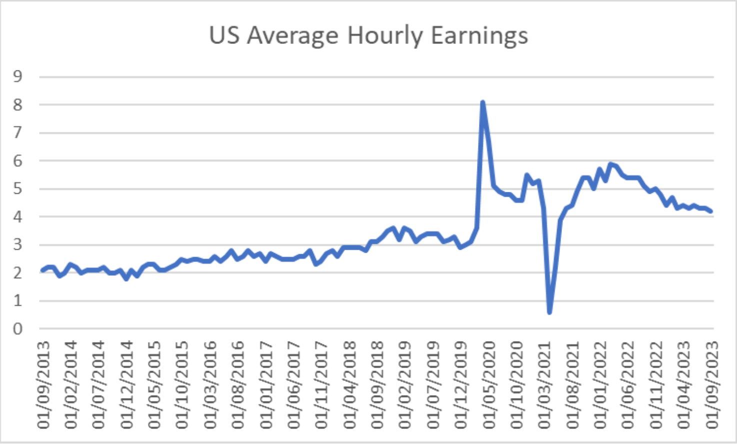
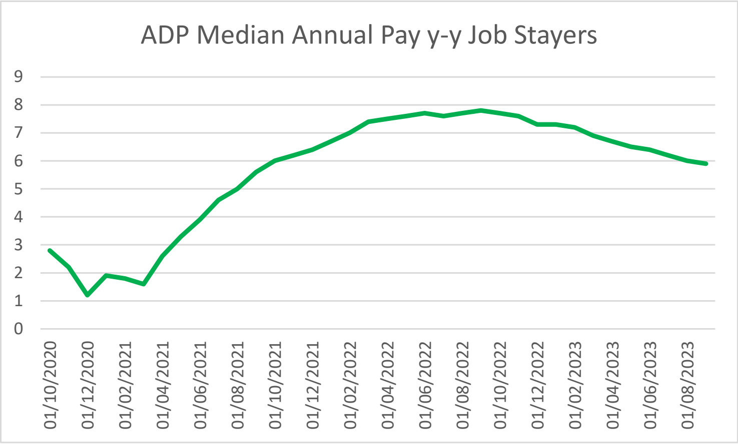
How much consumers can spend ultimately also depends on the wage developments and their savings. The most recent ADP National Employment Report covering the private sector states: "We are seeing a steady decline in wages in the past 12 months. Workers who stayed in their jobs saw a 5.9% median pay increase in September year-on-year (picture below left). That marked the smallest gain in two years. For those who changed the jobs, the 9% median rise in annual pay was the weakest since June 2021.

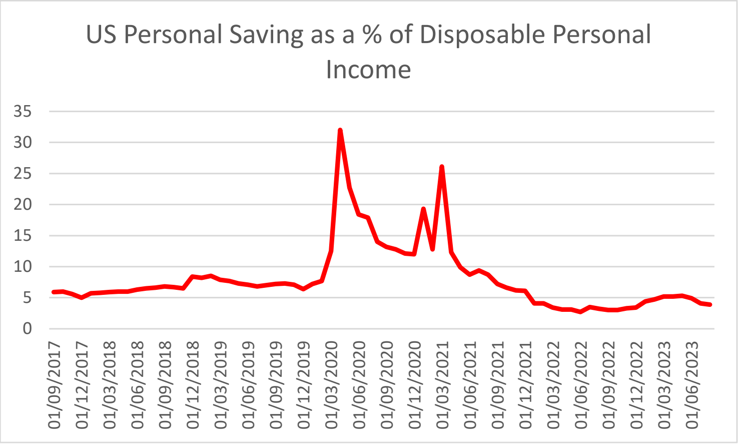
Also the widely followed labor report reflects deceleration in earnings pay growth (picture top right). This is all the more remarkable because payrolls have been much stronger than expected with upward revisions to the previous two months. The saving rate has dwindled from pandemic highs (picture below right).



Source: US Bureau of Labor Statistics



Source: Automatic Data Processing



Source: Bureau of Economic Analysis

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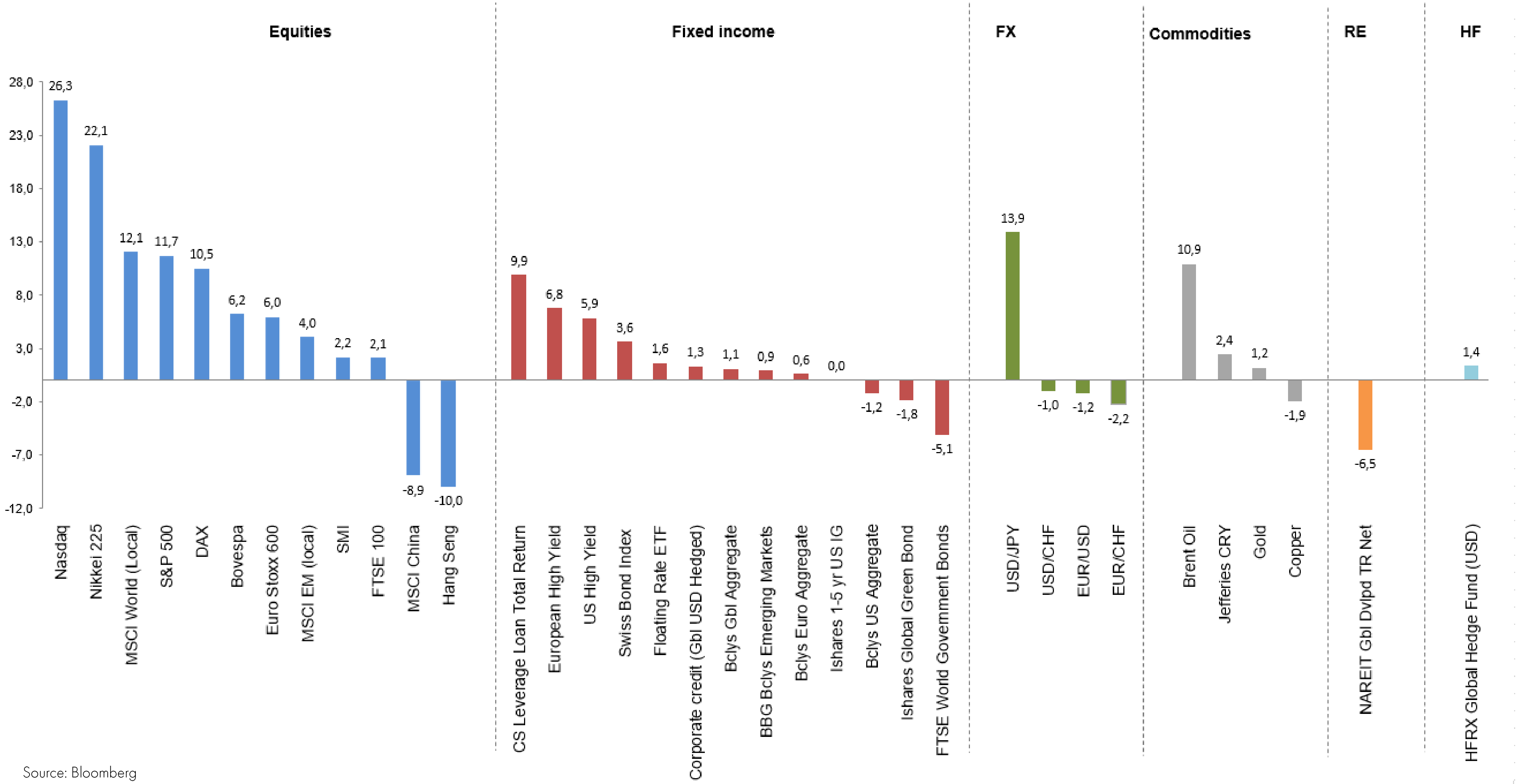
Conclusion

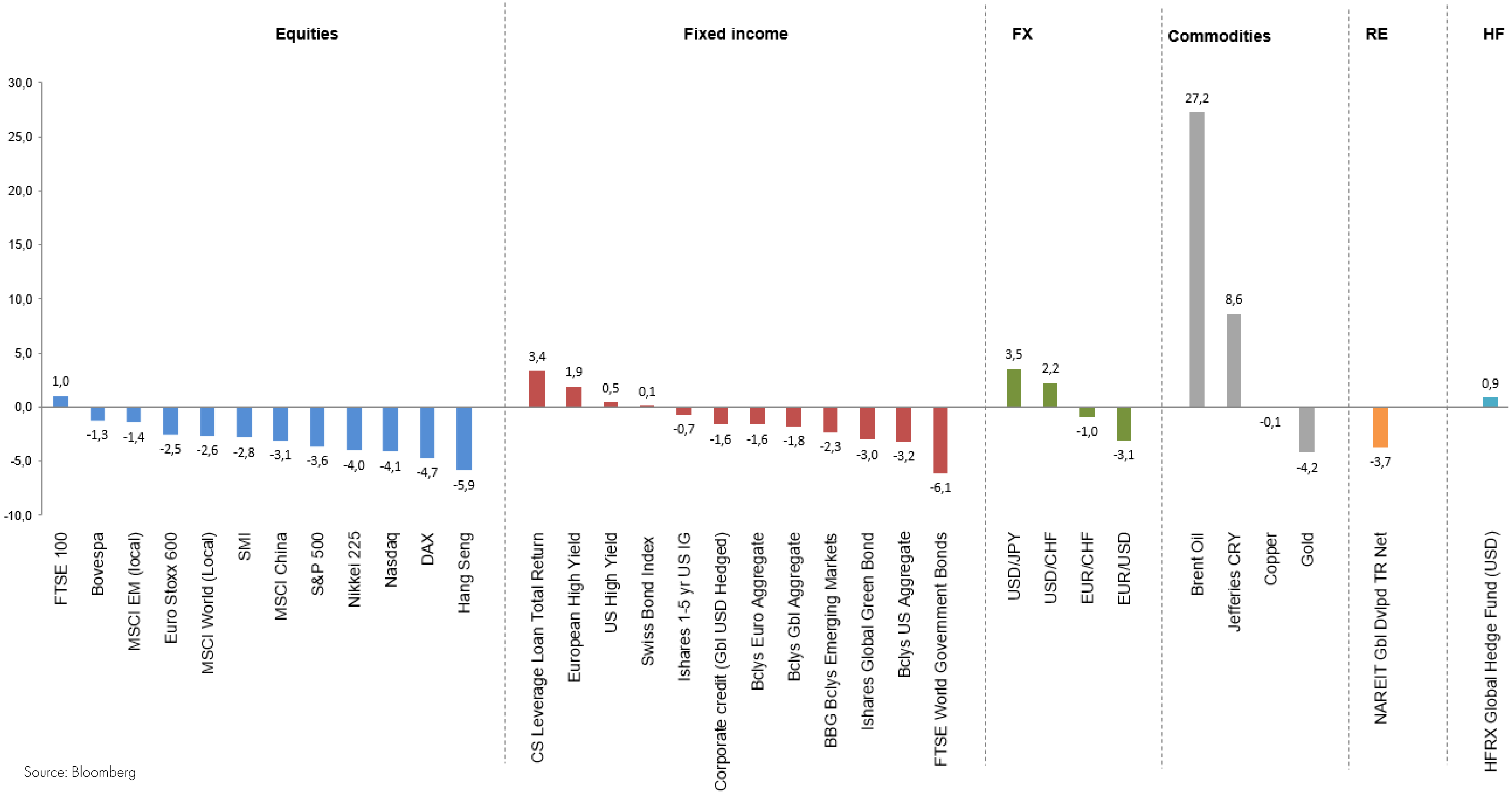
- The US has been suffering from weak economic growth for some time.
- Consumer spending remained resilient thanks to a robust labor market.
- Lower wage growth, higher borrowing costs, rising delinquency rates, costlier energy prices and very importantly the resumption of student loan payments threaten spending over coming months.
- On the positive side, business investments proved stronger than expected.
- Heightened political conflicts reduce visibility even more and are likely to discourage the Fed from taking more restrictive action.
- For the time being, we are of the opinion that a recession in the US could be prevented.
- Peak interest rates in the US should have been reached.
- Equity markets should refocus to earnings growth.
- For the earnings season that has just started, companies are expected to post profit declines of just 1.1%, followed by gains for at least the next year.
- Infrastructure spending, military expenditures and investment needs due to de-globalization are not dependent on interest rates.

Performance major asset classes year-to-date 2023 in local currencies



Source: Bloomberg

Performance major asset classes Q3 2023 in local currencies



Source: Bloomberg

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