



MONTHLY ISSUE #117 | 1st October 2024

Roja vs. Mannschaft, the economic match-up

EDITORIAL VIEW

- The fortunes of Spain and Germany have been very different over the past few years
- Spanish strengths: energy/economic diversification, tourism, public policies...
- German shortcomings: dependence on manufacturing and Russian gas, ageing demography...

GLOBAL STRATEGY

- The Fed easing started with a bang, but beware of the challenging route ahead
- The (growth) show goes on, providing a key support to equity markets
- Gold should prove a better safe haven, and continues to fare better, than government bonds

ASSET ALLOCATION

- Tactical allocation – No major changes: the time has come... to stay put
- Equity – Neutral stance reaffirmed, as the (growth) show goes on
- Commodities – In gold we trust (upgraded to overweight)

EDITORIAL VIEW

Roja vs. Mannschaft, the economic match-up

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Since the breakout of the war between Russia and Ukraine, the Spanish economy has proved remarkably resilient, outperforming its German peer - despite the latter being generally considered the engine of Europe. A dynamic that was also evident at the recent Euro 2024 tournament, where the Spanish team claimed the overall trophy after eliminating host nation Germany in the quarterfinals.

The degree of energy dependence is a major factor behind these different trajectories. Germany, a heavy user of Russian gas, has borne the brunt of sanctions and energy supply disruptions. This led to increased production costs and high inflation, approaching 6% in 2023. Spain, on the other hand, was less dependent on Russian gas and boasts a better mix of energy sources, particularly renewable ones. Inflation thus remained more moderate, at 3.5%. Diversifying its play and adapting to opponent strategies is indeed also what enabled La Roja to win crucial Euro 2024 matches.

The tourism sector, key to the Spanish economy, rebounded strongly after the pandemic. Millions of visitors flocked to the country in 2023, not only boosting GDP growth, but also creating jobs and supporting small local businesses. Germany, although also a tourist destination, is clearly no match for Spain in this regard. To draw another football parallel, the fact that the Spanish team was able to capitalise on its strengths, in this case a talented attack and a solid defence, contributed greatly to its Euro 2024 champion title.

It is also worth noting that where Germany faces major structural challenges, notably an ageing population and a dependence on manufacturing, Spain has been able to carry out structural reforms to improve the competitiveness and flexibility of its workforce. Encouraging innovation, supporting start-ups, strengthening education and vocational training; these are just some of the measures designed to help the country better adapt to the new post-COVID economic

realities. Just as the Spanish football team was able to reinvent itself and integrate young talents (Lamine Yamal and Nico Williams spring to mind).

Beyond tourism, Spain has invested heavily in sectors such as information technology, renewable energies and financial services during recent years. Such diversification has helped its economy better withstand external shocks. Germany, on the other hand, remains heavily dependent on manufacturing, which has been hard hit by supply chain disruptions and fluctuations in global demand. Similarly, the Mannschaft, despite its talent and prestigious history, has shown signs of vulnerability when facing more diversified rivals.

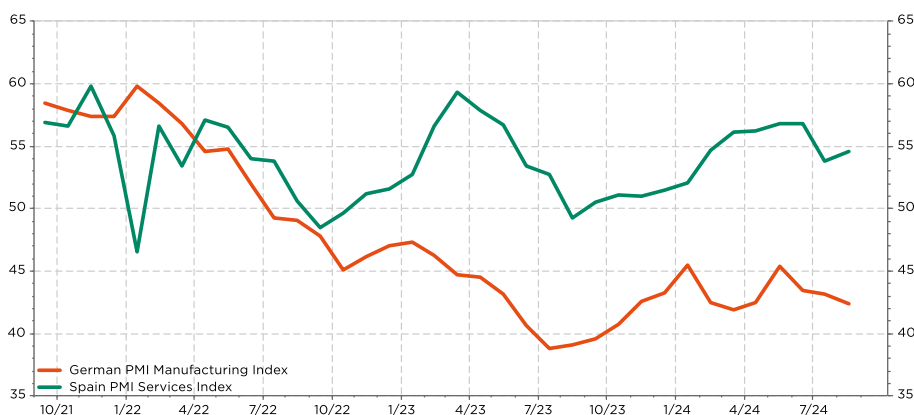
Lastly, fiscal and monetary policies have also played a crucial role in the Spanish economic resilience. Authorities implemented support measures for businesses and households, including subsidies, tax cuts and employment support programmes - which served to stabilise the economy and sustain domestic demand. Similar measures were also deployed in Germany, but have been less effective, because of the above-mentioned energy and structural factors. In the same way as injuries and tactical errors hampered the German coach's strategic decisions during the Euro 2024.

In short, Germany's industrial economy, once a model of success, is struggling to address the challenges of today's world. Spain, with its diversified and resilient services model, is meanwhile an example of successful adaptation to these new post-COVID economic realities. Let us wager that German policymakers, like the Mannschaft members, might have to rethink their strategies and bring in some new talent to move back up in the league. The Spanish team, meanwhile, should continue to shine on the international stage.

Written by François Botta, Senior Portfolio Manager

GRAPH OF THE MONTH

Divergent trajectories: German manufacturing PMI vs. Spanish services PMI



GLOBAL STRATEGY

Do the right thing!

- The Fed easing started with a bang, but beware of the challenging route ahead
- The (growth) show goes on, providing a key support to equity markets
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As markets had guesstimated, the Fed delivered a 50bp rate cut as the starting point to its easing cycle. This dovish decision was motivated by a recent deterioration in the labour market, with inflation having also dropped more rapidly than forecasted by Fed members last June. As a result, the Fed now sees the risks to its employment and inflation goals as roughly balanced, while still expecting resilient economic growth (unchanged GDP growth projections). Its choice of a preventive recalibration of monetary policy, rather than a cure later should a recession take hold, has probably increased the odds of our soft-landing scenario.

On this subject, it is worth highlighting two unusual points compared to previous easing cycles. First, such recalibration is consistent with the Fed's main concern swinging from inflation to the labour market: the Fed can let go a little on one of these objectives and focus somewhat more on the other. This means that, contrary to previous easing cycles, rising unemployment is not synonymous of a recession. It could eventually become so, but not at this (early) stage. The second point, which is a corollary to the first, is that the Fed is cutting rates from a position of economic strength, not weakness, with still some sticky inflation in services. History is thus no longer a guide. Not only may the classic trading playbook for periods of rate cuts (such as reducing equity exposure, buying defensive stocks, increasing bond positions, especially sovereign duration, and decreasing credit, to mention just the basics) not work this time round, but the Fed's easing pathway could prove more challenging – and therefore bumpier – than usual.

With recession fears receding, positioning/sentiment indicators stabilising at a more neutral level, and normal liquidity conditions restored after the summer break, global equity markets have resumed their advance, reaching new highs for the year on the back of solid 2024/2025 EPS growth estimates. Valuations are not cheap, but that is not new – and today's elevated equity index multiples conceal a much more complex reality, with segments such as Europe and small-caps still

offering attractive value beyond the “magnificent” US titans. Moreover, supportive macro and micro fundamentals, alongside lower rates, should warrant a re-rating of these segments.

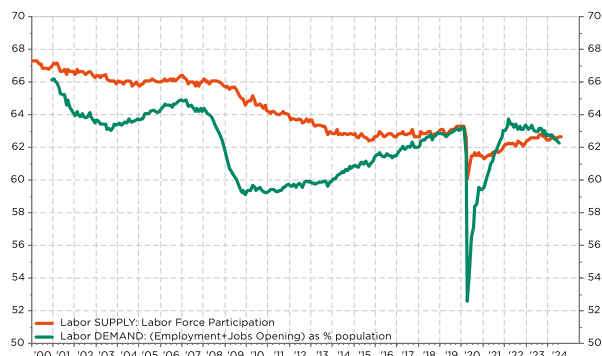
As a result, we remain constructive on equities but still expect bouts of market volatility (be they due to the nature of the economic landing, geopolitics, the monetary easing pathway, the inflation trajectory or market rotations, amongst others). These are likely to drive some price consolidation, possibly suggesting more muted near-term returns. At the portfolio level, it means that we stick to our (structural) preference for US equity markets, with a pinch of (actively managed) small- and mid-caps and a diversified S&P 500 equal-weight index allocation, which should benefit most from lower rates and overall cost pressures. Elsewhere, we already lowered our eurozone equity stance (to slight underweight) last month, amid growth that is again petering out and with Germany still struggling. We continue to prefer other European markets, such as the UK and Switzerland.

Finally, we retain a cautiously neutral stance on bonds, with a preference for credit at the short end and belly of the curve vs. long-term sovereign debt, combined with a diversification in gold (upgraded to overweight), which is not only benefitting from the Fed's anticipated easing cycle but could also prove a better safe haven than sovereign bonds in the event of US political turmoil, additional budgetary slippage concerns or a no-landing scenario (Fed policy mistake by cutting rates too soon/too much).

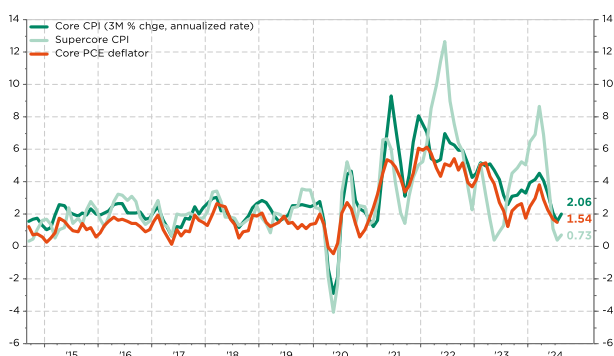
To sum up, we remain cautiously optimistic and continue to favour an all-terrain approach to portfolio construction, with a well-balanced diversified asset and sector allocation tilted towards high-quality plays in equities, a preference for credit carry and high-quality duration convexity in bonds, and a tangible allocation to gold, combined with USD and CHF exposure, as risk diversifiers.

Written by Fabrizio Quirighetti, CIO, Head of multi-asset and fixed income strategies

US labour market: supply now exceeds demand



US inflation: back on track to give Fed enough comfort



CONTACT

DECALIA SA
Rue du Rhône 31
CH-1204 Genève

Tél. +41 (0)22 989 89 89
Fax +41 (0)22 310 44 27

info@decalia.com
www.decalia.com

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External sources include: LSEG Datastream, Bloomberg, FactSet.

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