



## The Walker and his Dog Navigating Market Noise

### Economic Overview

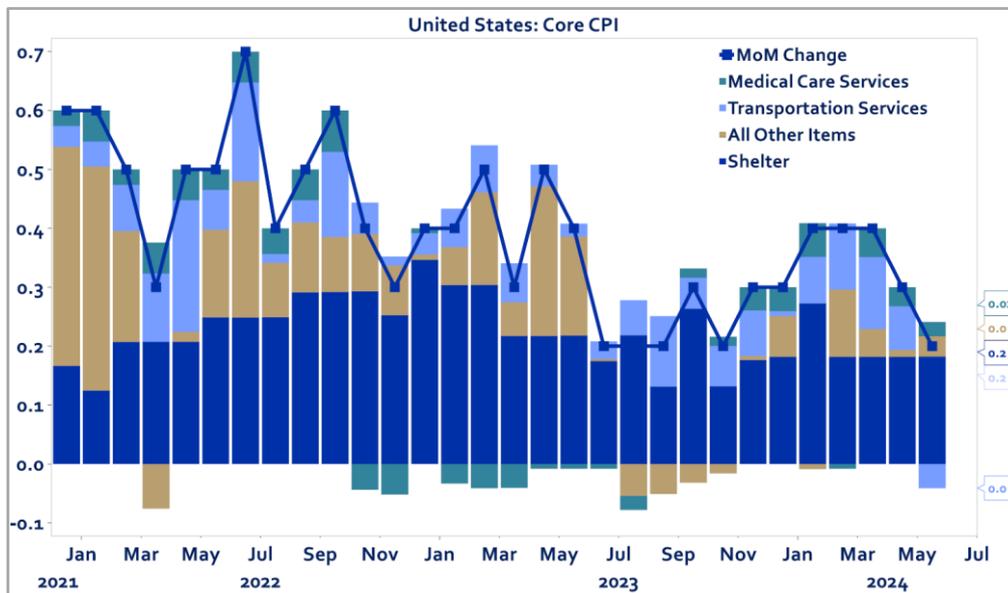
Since the end of 2023, global growth has remained robust while becoming less dependent on the American economy. Europe has finally rebounded, and the recovery in the global manufacturing sector has supported growth in emerging markets, which also benefit from elevated commodity prices. While aligned with this global economic strength, H2O AM's primary outlook at the start of the year also anticipated positive but slower growth and lower inflation for the US, with limited risk of shocks that could turn this deceleration into a protracted recession. However, potential upside factors prompted the team to assign a non-trivial probability to the risk of sustained growth and delayed monetary easing initiatives.

This theme of "regained momentum" has so far prevailed in the first half of 2024. Key drivers supporting this resilience have been the high public deficit (-7% of GDP despite the unsustainable debt trajectory) along with the sustained wealth effect in the United States, driven by substantial household holdings in stocks. Notably, US private sector financial assets is almost six times GDP, with over 40% of this wealth invested in equities.

### The Horizon Ahead

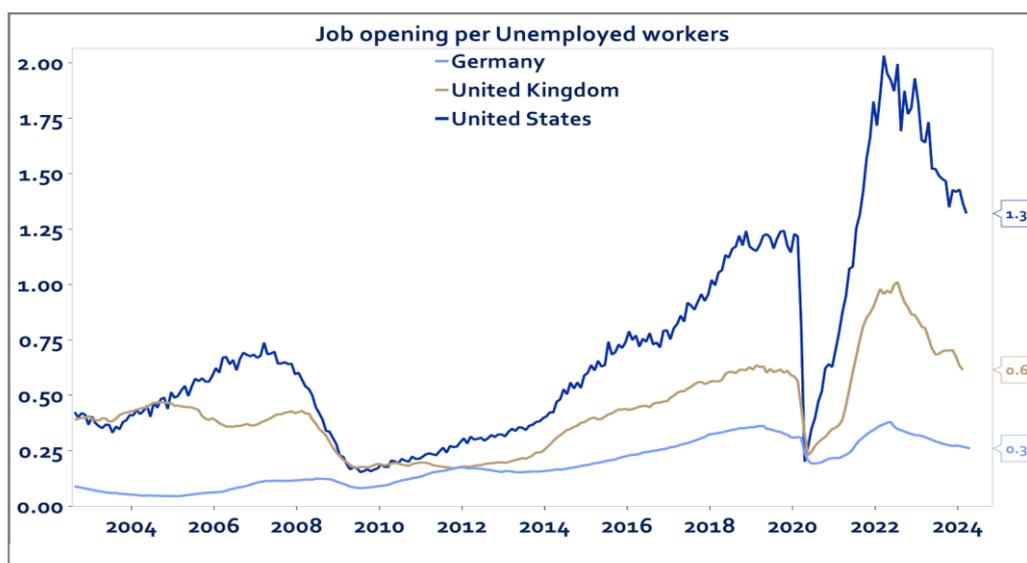
As we enter the latter half of the year, the management team has opted to maintain a similar scenario centred on a soft landing of the US economy, given growing evidence that factors hindering the disinflationary process are now fading. Certain components of core CPI, such as shelter, OER and transportation services, are beginning to normalise with a lag. Furthermore, the impact of increased immigration, which initially sustains inflation through

heightened demand, is now easing through its limiting force over secondary effects on wages.



Source: H2O AM & Macrobond (May 2024); core CPI excludes volatile prices such as food & energy

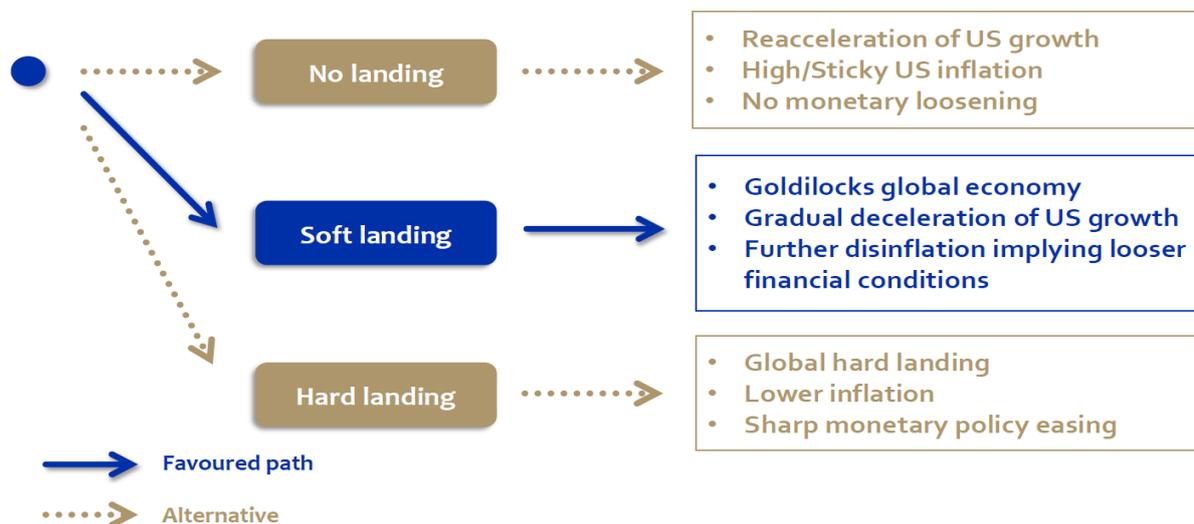
In fact, core-service inflation is heavily influenced by labour market conditions. At the end of the Covid crisis, global labour markets tightened significantly, eliminating the option for economies to substitute local workforce shortages with unused labour capacity from neighbouring regions. This inflationary trend has also begun to moderate noticeably last year, alleviating price pressures driven by wage-induced demand. This insight is crucial as it predominantly shapes central banks' ability to decisively embark on a rate-cutting cycle as soon as their credibility is no longer at stake.



Source: H2O AM & Macrobond (April 2024)

Consequently, central banks like the ECB face fewer question marks in their rate cuts trajectory compared to the Federal Reserve. In the Eurozone, inflation has primarily stemmed from input costs and supply constraints rather than demand-side factors such as the wealth effect and fiscal impulse in the US, thereby reducing the risk of monetary policy missteps.

Now, factors contributing to a slowdown in the US are gaining prominence, reinforcing our confidence in our initial projection for a synchronised downturn. Specifically, growth is expected to decelerate due to the lagged effect of elevated interest rates, disproportionately affecting vulnerable segments of the economy such as small businesses, asset-limited households, and younger demographics. The consumer credit delinquency rate has begun to rise, particularly among low-income and young households, while bank credit growth has sharply decelerated. Additionally, small businesses are feeling the full impact of rate hikes, leading them to lower their capital expenditure plans and reduce hiring intentions.



Source: H2O AM (June 2024)

## Building Resilient Portfolios

Despite entering a phase of reduced macroeconomic uncertainty, market volatility remains a crucial factor that demands monitoring. In this analogy, macroeconomics can be likened to a walker heading in a set direction, while the market resembles a dog on a retractable leash, running around unpredictably. During periods of heightened macro variance (the walker increases their pace), the market tends to adjust mostly in the same direction. However, when economic conditions stabilise into a more predictable environment (the walker slows down), the market gains the freedom to move in various, or even opposite, directions. And of course, the leash is long and can further extend in the wrong direction as investors fall into behavioural traps or cognitive biases. This creates a paradox: at times, assets prices can move opposite to macroeconomic trends. In essence, 2024 marks a departure from the past three years, increasingly reflecting market-driven dynamics rather than economic influences.

While macroeconomics serves as the compass guiding strategy, H2O AM's approach in such environments is to construct portfolios robust enough to benefit from, rather than endure, market volatility. This involves managing portfolios capable of navigating shifts in market sentiment triggered by unforeseen divergence between anticipations and macroeconomic outcomes. In practice, such approach necessitates employing multi-scenario strategies to enhance portfolio resilience over the investment horizon.

The bond market serves as a recent example of such opportunities. At the end of 2023, investor sentiment also favoured a soft-landing scenario, anticipating minimal growth acceleration. However, within six months, expectation transitioned to a 'no landing' scenario, with reduced forecasts for meaningful rate cuts this year. This sentiment swing granted renewed defensive potential for bonds, which should now offer protection during periods of heightened market stress.

While hedging strategies adapt to these dynamics, the core performance engine of H2O portfolios remains stable, grounded in fundamentals. Emerging assets, despite recent volatility stemming from political shifts, exemplify this stability by maintaining their significance in our strategic allocation. This commitment persists because these assets continue to align favourably across metrics such as valuation, risk premium, positioning, and exposure to prevailing economic trends. If anything, their collective alignment on these parameters has improved in recent months, especially regarding value and premium.

For instance, the recent correction in the value of the MXN is viewed favourably within this framework. While portfolios only gave back a portion of the premium accumulated since 2023, the currency's retracement to last year's valuation levels exhibits renewed returns potential with a cleaner market positioning. The key to capturing value from such long-term themes lies in remaining invested in positions, adjusting exposure during periods of stress, and steering portfolios to withstand volatility and mitigate drawdowns.

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