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Briefing from the ARVEST Investment Committee

The global economy grew in the 3rd quarter of 2023 despite weak industrial production. This was mainly due to strong consumption of services and the resilient labor market in the USA. Thanks to savings during the pandemic, U.S. household consumption remains high. China appears to be recovering from a cyclical bottom, however structural challenges remain enormous after the bursting of the real estate bubble. Germany, the economic engine of Europe, is sputtering badly. Many emerging economies, on the other hand, are growing at a largely stable pace thanks to strong consumer demand. Inflation remains high, especially in the western countries, but is falling steadily.

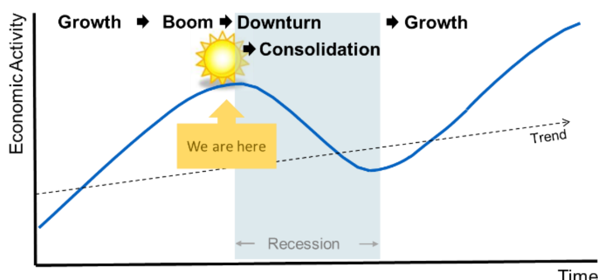
Global economic trends thus continued in the quarter under review. This is remarkable given that last winter almost all economists and market participants assumed that the US economy would be in a recession by now. Meanwhile, the consensus view is for a soft landing in the coming quarters. A soft landing is defined as a period of economic weakness, usually in the midst of a cyclical upturn, that does not meet the criteria of a recession. This means that there is no profound, prolonged and pervasive decline in economic activity that extends to the labor market and consumption. A soft landing is the goal of any central bank when it needs to raise interest rates to fight inflation and cool the economy. In the last eleven US rate-hike cycles[1], only then Fed Chairman Alan Greenspan clearly succeeded in 1995. Other possible candidates are 1966 and 1984, although the rate hikes then were hardly restrictive, so there can be no talk of a "landing" at all. A soft landing is therefore a rare but possible scenario that should be considered in any investment strategy.

The Effective Federal Funds Rate, 1965–2021

Source: Board of Governors of the Federal Reserve System

[1] Landings, Soft and Hard, The Fed 1965-2022, Journal of Economic Perspectives Winter 2023

The ARVEST Investment Committee roughly divides the economic cycle into four phases: growth, boom, downturn (crash) and consolidation. We maintain our view that the US is in a boom phase. This means that we still consider the probability of a US recession to be too high to justify an above-average equity exposure.



Recession warnings have eased somewhat in recent months, including in the models we use, in part due to the significant decline in US inflation. Our models are generally optimized for a lead time of six to twelve months, making them useful for long-term investors with a steady hand. However, the exact timing of the models is uncertain, which means that the effective lead times have varied widely in past recessions. According to the models, this time a recession could start as late as summer of 2024. After the inflation shock, we believe the global economy remains vulnerable to a growth shock.

Future Prospects

Trade outside the US and Europe will shape future economic development and change the global economic order. The opportunities and risks in China are therefore important in the medium term. For the financial markets, however, the US business cycle will remain the key driver over the next twelve months. US government bonds remain the largest and most liquid investment instrument in the world. They form the basis of the world's reserve currency, the US dollar. In addition, US companies account for approximately 60% of the stock market capitalization of all countries.

US equity markets continue to be overvalued, especially relative to fixed income. The market indices are highly concentrated in large-cap technology companies. A recession in the US economy could lead to sharp declines in equity prices. As a hedge against an economic downturn and sharp interest rate cuts, US prime bonds are attractive. Despite falling inflation, their yields have continued to rise in recent months. However, the currency risk of the US dollar should also be increasingly hedged. US government debt is high. The trade and budget deficits are unlikely to decline in a US election year. In addition, global demand for US foreign exchange reserves appears to be declining.

We reduced the equity allocation in the portfolios some time ago and are keeping it stable. Quality stocks with secure dividends and truly global diversification remain essential for us. Moreover, the economic cycle in China and Japan is more favorable than in the US or Europe. In our view, it is still too early for a "full" re-entry into the equity market. Short- and medium-term bonds with a low risk of default, as well as money market investments, look very attractive to us.

9 October 2023
On behalf of the Investment Committee
Stefan Kimmel
Chief Investment Officer ARVEST Funds AG

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