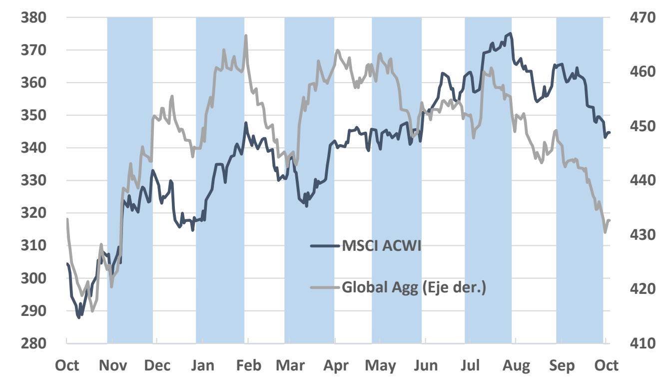
## High rates for a longer period of time.

September was another negative month for both bonds and stocks. Global equities fell 4.1%, led by the S&P 500, which declined 4.5%, closing the worst quarter of the year and the only one in the red. Investment grade bonds lost 2.9% globally and 2.5% in the United States. The markets were mainly affected by a sharp rise in long interest rates.

**Another month in the red for stocks and bonds**

MSCI ACWI (global equities) vs. Bloomberg Global Agg (bonds)



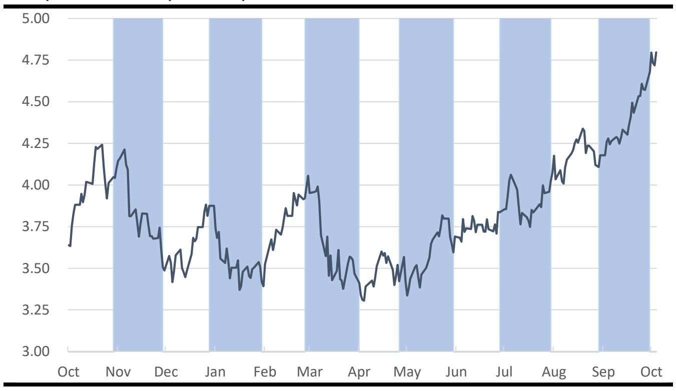

Source: Bloomberg

The decline deepened after the Fed meeting, which took place in the third week of the month, when the S&P 500 had its two worst days. In the last 10 days of the month, declines were double those of the first 20 days.

Following the meeting, the Fed's main message was that interest rates would remain high for longer than the market expected. The rate cut projection for 2024 was halved with no increase in inflation expected. Therefore, the market began to assume higher nominal and real rates. The Fed justified its more aggressive monetary stance on the strength of the economy, correcting upward the growth expectation significantly. It now expects 2.1% growth for 2023, double the June projection and well above the 0.5% expected at the end of 2022.

**Long bonds out of control**

10-year treasury bond yield




Source: Bloomberg

The fixed income market is also reflecting the serious funding problems facing the U.S. government. First, the Fed kept its quantitative tightening program unchanged, expecting to buy back US$ 0.7 trillion of Treasury bonds over the next 12 months. Second, a fiscal deficit of at least US$ 1.5 trillion per year, which has been accentuated by interest costs, must be financed. In addition, the political system has levels of conflict and institutional weakness that make it difficult to take appropriate measures. Finally, the Treasury faces the need to refinance USD 7.6 trillion in existing bonds.

In addition to the rate hike, there are other reasons to remain cautious. First, there are incipient signs that the U.S. economy is beginning to lose momentum. Analysts generally believe that a soft landing is possible, although historically such a consensus has preceded recessions. Second, stocks remain expensive by historical standards and are becoming less attractive relative to bonds, whose yields are at a

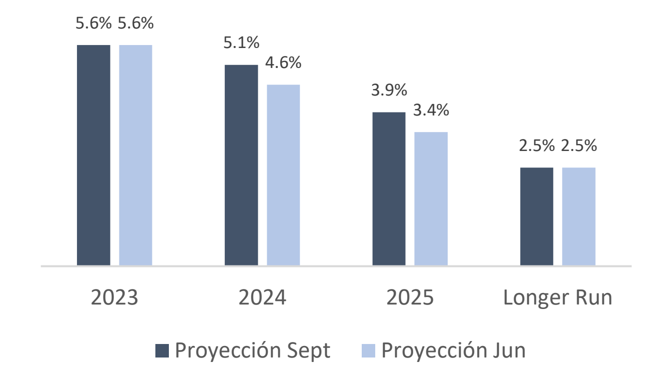
16-year high. Finally, the global economy looks vulnerable. Europe is showing signs of recession and China is failing to take off.

## 10-year rate soars after Fed meeting

The 10-year rate hike was magnified following the Fed's recent meeting, which decided to keep interest rates unchanged. The pause was considered "hawkish", as the Fed not only reiterated that it would raise rates another 25bp before the end of the year, but, in its quarterly economic projections, estimated that it will cut rates by 50bp in 2024, half of the 100bp estimated in June. They would therefore stand at 5.6% at the end of 2023 (from 5.3% currently) and 5.1% at the end of 2024.

**The Fed signaled higher rates for longer**

Fed projections for the benchmark rate.

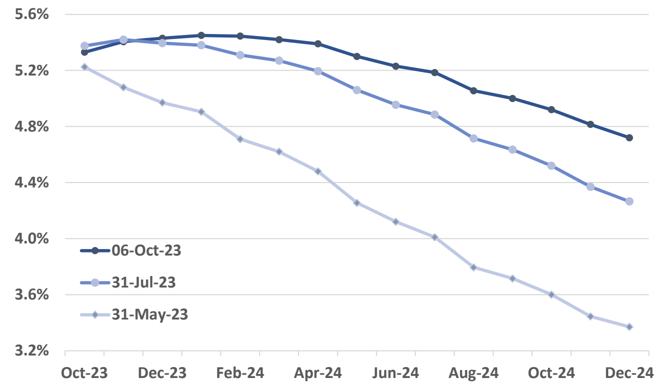



Source: FOMC Meeting

The higher rates are a consequence of an increase in its expectations for economic growth and a slower fall in inflation and unemployment. According to the Fed, the economy would grow 2.1% this year, double the previous estimate, and 1.5% in 2024, higher than the previous 1.1%. Core inflation projections for 2024 remained unchanged at 2.6% and rose slightly to 2.3% in 2025, to reach the 2% target only in 2026. Unemployment would remain at 3.8% in 2023 and 4.1% in 2024, both 0.3%-0.4% lower than the previous estimate. This implies a "soft landing" scenario, in which inflation falls without an economic debacle or substantial job loss, something so difficult that it has only been achieved once in recent decades. On most occasions, inflation only came down after suffering economic recessions.

**The market raised its rate estimates sharply**

Fed rate futures




Source: Bloomberg

As a result of the Fed's higher rate projections, the market began to assume that rates will remain at elevated levels for a long time. This is contrary to long-held expectations in the futures market, which assumed a rapid decline. Now, investors expect Fed rates at the end of 2024 to reach 4.7%, compared to the 4.2% estimated at the end of July and 3.8% at the end of June. This new scenario of lasting high rates is a consequence of the Fed believing for too long that inflation, which began to rise in 2021, was a transitory phenomenon, coupled with the decision to raise rates below inflation levels, contrary to the strategy in previous cycles. By the time inflation reached 9% in June 2022, Fed rates had not even reached 2%.

Long bond yields are at levels well above current inflation and expectations. At 4.8%, the yield on the 10-year bond more than doubles the long-term inflation projected by analysts and the bond market and more than 100bp above current inflation records. TIPS, whose principal is adjusted in line with consumer inflation, offer a yield 2.5% above future inflation, the highest in 15 years. Just two years ago, those same bonds offered a negative 1% rate.

**Inflation-adjusted bonds at very attractive levels**

10-year TIP yield (%)


Source: Bloomberg

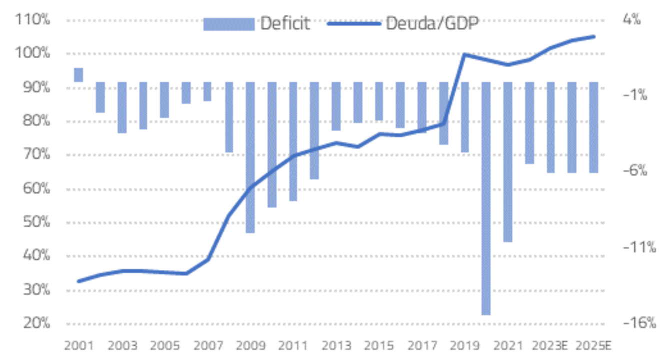
## The U.S. faces a mountain of maturities.

The fiscal situation in the United States is a major concern for the bond market. The treasury is going to have to issue unprecedented amounts of debt to finance the deep fiscal deficit, roll over high maturities and at the same time repay maturities of securities held by the Federal Reserve.

Fiscal spending has increased significantly in recent times, mainly for non-discretionary items. The U.S. Budget Office estimates a fiscal deficit of 6%-7% of GDP over the next three years, similar to those during recessions or wars, which is unprecedented for an economy with unemployment below 4%.

**U.S. Fiscal Deficit.**

Evolution of fiscal deficit and total debt for the U.S.

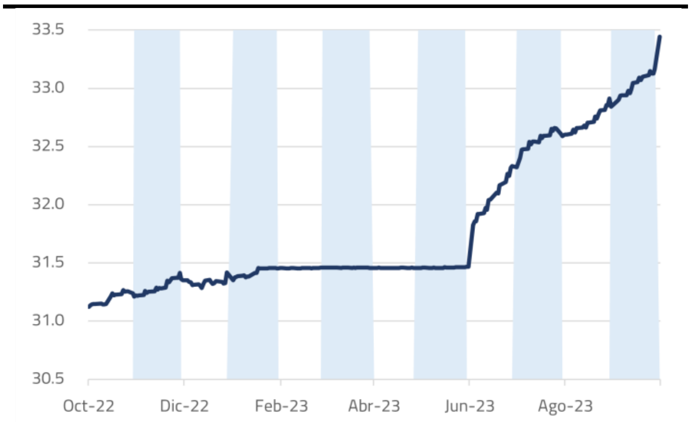



Source: Bloomberg

In addition, part of the current record debt of US$ 33 trillion needs to be refinanced. In the coming year alone, the treasury faces maturities of US$ 7.6 trillion, equivalent to 30% of the debt held by the public, which today pay much lower interest rates than the current ones.

**Record level of U.S. Debt**

U.S. Federal Debt in billions of dollars




Source: Bloomberg

This situation generates two problems. The first is that the increase in interest rates leads to an even higher deficit. Not only are interest rates as high as in 2007, but the debt is much higher. At that time, debt represented 35% of GDP, while today it is close to 100%. Therefore, it is estimated that interest expenditure represents

2.5% of GDP, reaching 3.2% in 2030. This would be a historical record, surpassing even national defense spending. The second problem is the large amount of debt to be issued coincident with the implementation of the quantitative tightening program that increases the supply of bonds in the market. The Federal Reserve continues to reduce the amount of Treasuries on its balance sheet by the equivalent of US$60 billion per month, generating a supply of US$0.7 trillion of securities. All of these elements significantly increase the supply of securities in the market, putting upward pressure on longer interest rates, and therefore pushing bond prices down.

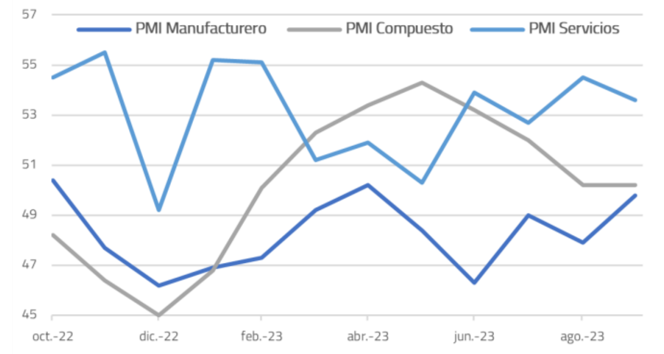
## Global economy cools down

The global economy is slowing. While the U.S. economy remains robust, the third quarter will likely mark the peak of growth. On the other hand, growth in the Eurozone remains anemic, and China is expected to grow less than expected in 2024, as a consequence of the still unresolved real estate crisis.

In the United States, projections no longer show a recession. In August, new orders for durable goods, a measure of manufacturing activity, grew 0.2% m/m, higher than expected after falling 5.6% in July. In line with the evolution of manufacturing PMIs, which, although still in contractionary territory, surprised to the upside.

**PMIs United States**

Economic activity in the United States



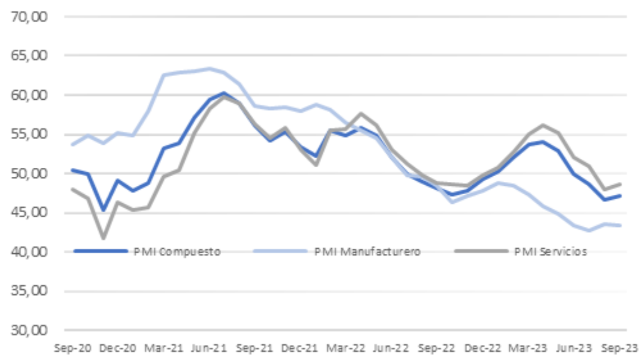

Source: Bloomberg

However, consumer confidence weakened in September for the second consecutive month, reaching the lowest level since May, and the expectations index collapsed to 74 from 83 in August. Historically, levels below 80 have preceded recessions in the following 12 months. In addition, the housing market continued to show the impact of the sharp rise in mortgage costs, which reached 7.75%, the highest level in more than 20 years, as pending sales fell 7.1% m/m and 18.8% y/y in August.

Europe does not have encouraging growth expectations going forward. The September Manufacturing PMI was 43.4, slightly lower than August's 43.5. In addition, second-quarter GDP posted a 0.5% YoY decline and July retail sales fell 1.0% YoY.

**PMI Europe**

Economic activity in Europe




Source: Bloomberg

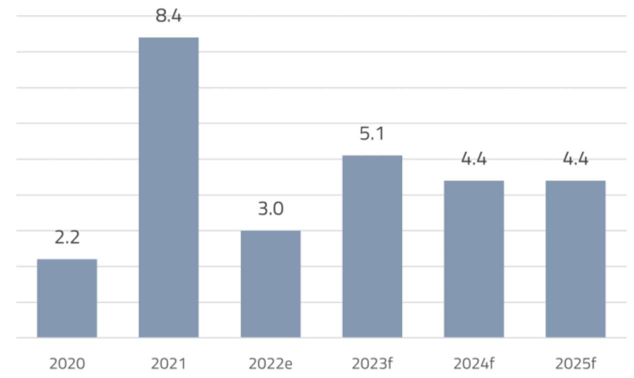
On the other hand, the European Central Bank (ECB) meeting reduced the Real GDP forecast from 0.9% to 0.7% for 2023, and from 1.5% to 1.0% in 2024. In addition, the ECB raised the benchmark rate by 25 basis points in response to inflation that still remains far from 2%. The ECB's macroeconomic projections foresee inflation of 5.6% this year and 3.2% in 2024.

However, preliminary data for September revealed that both core and headline inflation decelerated below expectations. Headline was 4.3% YoY, down significantly from 5.2% in August. Core inflation also fell, coming in at 4.5% YoY, versus estimates of 4.8%.

For its part, the World Bank has just lowered its growth expectations for China in 2024. It now expects growth of 4.4% against the 4.8% forecast in April. Little by little, the expected growth is moving away from the 5% target that the government had set at the beginning of the year.

**China Growth Expectations**

World Bank's GDP growth expectations China




Source: World Bank

However, recently released data bring some hope. In August, retail sales rebounded 4.6% YoY, driven by services and tourism. On the other hand, industrial production rose 4.5% (the highest increase since April), exports fell less than the previous month and credit grew 9% YoY. August also saw a return to positive inflation, after a period of deflation. This was reflected in an equity market decline of 2.4%-2.5%, more modest than in the rest of the world.

| American Stocks | 1M | YTD |
|---|---|---|
| DJIA | -3,4% | 2,7% |
| Nasdaq Composite | -5,8% | 27,1% |
| S&P 500 | -4,8% | 13,1% |
| Russell 2000 | -5,9% | 2,5% |
| Rusell 1000 Value | -3,9% | 1,8% |
| Rusell 1000 Growth | -5,4% | 25,0% |
| Rusell 1000 | -4,7% | 13,0% |

September fulfilled the tradition of being the worst month of the year for the S&P500. The rest of the stocks followed the fall, mainly those with growth characteristics. Technology stocks were the hardest hit, as they are the most affected by the rise in long rates, which have a greater impact on long term flows.

| Developed Markets (USD) | 1M | YTD |
|---|---|---|
| MSCI ACWI | -4,1% | 10,1% |
| MSCI ACWI ex-US | -3,2% | 5,3% |
| MSCI World | -4,3% | 11,1% |
| MSCI World ex-US | -3,4% | 6,7% |
| Japan: Nikkei 225 | -4,2% | 9,2% |
| Stoxx Europe 600 | -4,1% | 8,3% |
| Germany: DAX | -5,9% | 9,1% |

Developed markets fell to a lesser extent than the U.S. Europe suffered from a weaker economy, continued tight monetary policy and above-target inflation. Japan, on the other hand, lost the enthusiasm of the first half of the year.

| Emerging Markets (USD) | 1M | YTD |
|---|---|---|
| MSCI EM | -2,6% | 1,8% |
| China: Shanghai Comp. | -2,5% | -7,8% |
| Hong Kong: Hang Seng | -2,4% | -7,2% |
| India: S&P BSE Sensex | 1,2% | 9,0% |
| Brazil: Bovespa | -0,9% | 11,4% |
| MSCI: México | -6,2% | 17,5% |
| Argentina: Merval | -15,2% | 18,2% |
| Chile: Santiago IPSA | -7,2% | 5,8% |

Emerging markets fell less than the rest of the world. China, despite the pessimism, fell just 2.5%, as some data are beginning to show some relief. The strong dollar had a negative impact on emerging markets.

| US Treasury Bonds | 1M | YTD |
|---|---|---|
| US Treasury 2 Yr | 18 | 62 |
| US Treasury 5 Yr | 35 | 61 |
| US Treasury 10 Yr | 46 | 70 |
| US Treasury 30 Yr | 49 | 74 |

For some months now, the curve continues to steepen through the rise in long rates. This is because the market no longer expects large hikes from the FED, which affect the short end, but expects more growth and debt issuance, which affects long rates.

| Fixed Income Indices (USD) | 1M | YTD |
|---|---|---|
| US HY | -1.2% | 5.9% |
| US IG | -2.5% | -1.2% |
| US GLOBAL | -2.4% | -0.6% |
| GLOBAL HY | -1.3% | 5.4% |
| GLOBAL IG | -2.9% | -2.2% |
| EM HY | -1.9% | 3.1% |
| EM IG | -2.5% | -0.3% |
| EM Global | -2.3% | 0.9% |

Low credit quality ('High Yield') fixed income markets had their second worst month of the year. The premium over sovereign debt is below the historical average and its high correlation with equities worked against it. On the other hand, good quality debt had a bad month, explained by the rise in longer interest rates. For the same reason, and exacerbated by the rising dollar, emerging market bonds also fell.

| Currencies | 1M | YTD |
|---|---|---|
| DXY | 2.5% | 2.6% |
| Euro | -2.5% | -1.2% |
| Yen | -2.6% | -12.2% |
| Libra | -3.7% | 1.0% |
| Yuan | -0.5% | -5.5% |
| Real | -1.6% | 4.9% |
| MSCI Emerging Mkts Currency | -0.5% | 0.5% |

The dollar continued to strengthen on rising rates and stronger U.S. growth versus the rest of the world.

| Commodities | 1M | YTD |
|---|---|---|
| BBG Commodity Index | -0.7% | -3.4% |
| BBG Agriculture Index | -4.6% | -7.7% |
| Oil | 9.7% | 10.9% |
| Gas | 5.8% | -34.5% |
| Oro | -4.7% | 1.3% |
| Plata | -9.3% | -7.4% |
| Cobre | -0.9% | -1.9% |
| Soja | -6.3% | -16.1% |
| Trigo | -5.5% | -31.6% |
| Maíz | 3.4% | -29.7% |
| Algodón | -1.4% | 4.2% |
| Ganado | 2.5% | 19.0% |
| Madera | 0.0% | -7.9% |

Energy prices stood out against the rest of the market. The price of a barrel of oil reached the highs of March 2022, although it then fell below 90 dollars. On the other hand, agricultural or 'soft' commodities fell significantly again, as rising energy costs have an impact on production costs. Precious metals fell as rates continued to rise and there was no panic sentimentt.

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