MARKET INSIGHT

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WHEN EUPHORIA HIDES FRAGILITY

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The traditional year-end crystal ball exercise, consisting of listing outlooks and convictions for the next 12 months, often resembles the art of divination – offering conclusions that usually become obsolete after just a few weeks, as soon as the unexpected rears its head again… This seems particularly true today after a year rich in uncertainties and a rather chaotic November. We prefer to focus on identifying major underlying risks and the market signals associated with them, in an attempt to gain clearer insight.

TENSIONS UNDER THE SURFACE

The challenges are numerous, and we cannot address them all here. As a starting point: the main stock indices are at, or flirting with, their all-time highs. This can certainly be explained by favourable economic fundamentals (global growth has clearly surprised on the upside this year compared to most forecasts) and very accommodative financial conditions. However, the underlying drivers are increasingly questionable, with excessive use of fiscal and monetary levers under the growing political influence of populist leaders.

Liquidity is abundant and has propelled most asset classes to stretched valuation levels, not to mention the almost disproportionate enthusiasm for AI, which adds to the prevailing euphoria – hopes that will inevitably be partially disappointed. For example, the book value of S&P 500 companies, as well as the discounted value of their expected earnings over three years, represents only about 30% of the index level, the rest being aptly described as "hopes and dreams". Let's keep in mind that over a 10-year horizon, initial asset valuations explain the vast majority of the variability in subsequent returns!

CRACKS ARE APPEARING

Are these stimulative policies reasonable, when the economy is robust and markets are sky-high? The flip side of the coin likely hides a resurgence of inflationary pressures, which no one seems to care about anymore – including monetary authorities, particularly the Fed. These pressures will be further fuelled by US tariffs, as the resulting price increases will eventually reach consumers sooner rather than later. Central banks, traditionally the arbiters of balance between growth and inflation, seem subject to unhealthy politicisation, as exemplified by the Federal Reserve, which skews their orthodoxy and undermines their credibility.

"Tangible warning signals are already visible today."

The "artificial" serenity observed so far, which notably leads to an underestimation of risks, is built on unstable foundations: already worrying levels of government debt are compounded by an inexorable widening of budget deficits, which should normally push "bond vigilantes" to demand higher yields to hold long-term sovereign bonds from countries with deteriorating public finances.

Tangible warning signals are already visible today: the rise in term premia, which intensify the steepening of yield curves, is a striking example – particularly in Japan, where the gap between the policy rate and the yield on 30-year Japanese Government Bonds has jumped by more than 2% since early 2022! In the United States, the 30-year treasury yield now stands above Fed Funds and is trending higher, despite 150 basis points of rate cuts initiated more than a year ago – something rarely seen in previous easing cycles. The second adjustment variable is the exchange rate, as evidenced by the weakness of the US dollar and the yen, while the Swiss franc soars!

How can such phenomena be curbed? If the situation worsens, recourse to unconventional policies such as quantitative easing and yield curve control will be inevitable. Measures that distort the "fair" remuneration of assets and penalise savings in artificially administered markets.

SET THE SCENE

Does that make us really pessimistic? No, but vigilant. Sisyphus undoubtedly still has enough strength to push his rock closer to the summit. We remain fully invested in equities but render our exposures asymmetric by implementing tactical protections, made attractive by low volatility levels. We also overweight real assets, which are not backed by liabilities and equally provide protection against inflation – a positioning to favour today. Gold and its impressive rise is a striking example!

Choosing good sharp ratios is also essential, such as the Swiss market among equities, or cash, as opposed to credit, which has become too expensive. Selecting quality debtors, such as private and sovereign and maintaining moderate duration is key in the bond world.

Diversification into emerging markets, which display better fundamentals than their developed counterparts, is also recommended. Finally, exposure to alternatives (hedge funds in particular) strengthens portfolio resilience in the event of rising volatility. Seatbelts are fastened to face a 2026 that could encounter turbulence!

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