

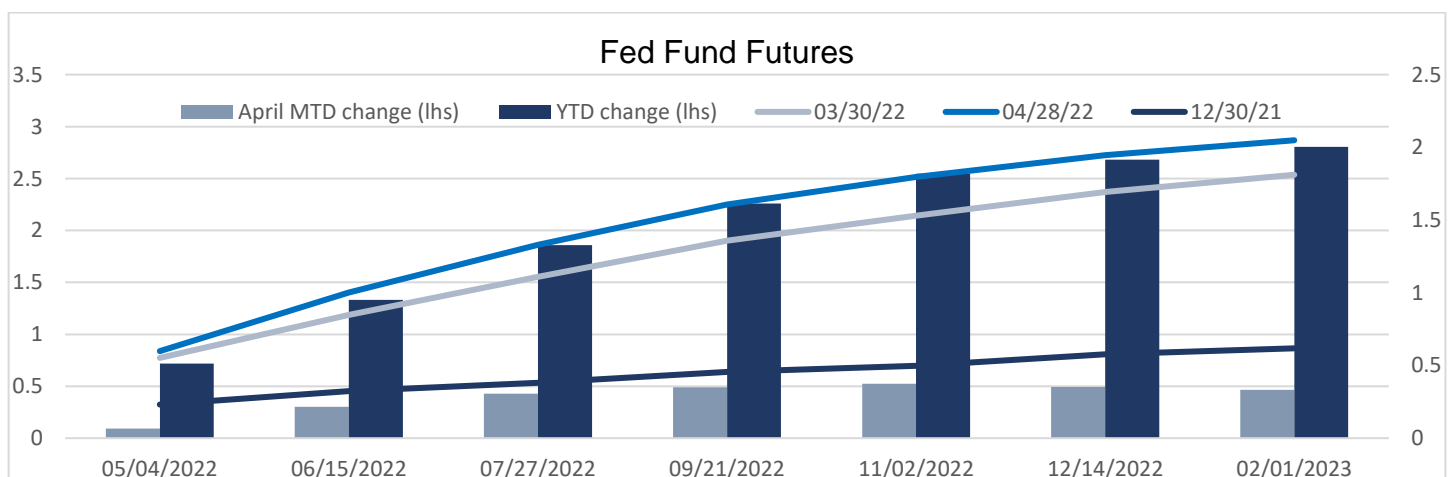
## Deflation continues on wallstreet!

The pressure was on for a sharp rebound in financial markets for the month of April as it is typically one of the strongest months for equities based on historical returns. It ended quite differently. With no resolution in sight for the war in Ukraine as the fighting even intensified in specific regions and with a relentlessly more hawkish rate hike trajectory signalled by the FED, the asset deflation continued on most financial assets. European equities held up better than US equities as the Stoxx 50 index ended the month of April -1.98% whereas the broader Stoxx 600 which includes UK and Swiss stocks ended down a mere -0.57%. The Swiss market index, known for its defensive stance, ended the month even higher at +0.85% with strong contributions from Novartis (+6.47%) and Nestle (+7.19%). Nestle reported solid earnings in April with a healthy gain in revenue and reiterating its forward year 2022 guidances. With its value tilt through the high concentration of stocks in the financial, energy, materials, and consumer staples sector (60%), the UK FTSE 100 also ended the month positively and is the only major equity index in Europe with a positive YTD return by the end of April. Unsurprisingly, the IT sector which has been smashed globally so far, only represents 1% in the FTSE 100.

Growth-style driven indices such as the S&P 500, or the Nasdaq, experienced their worst month of the year and the most complicated one since the start of the Covid-crisis in March 2020. While the S&P 500 lost 8.7% in April, the Nasdaq was down 13.2%. The drawdown (-13.8%) on the S&P 500 has now lasted 81 days through April 30th, 2022, with the peak being the all-time high on January 3rd, 2022. The Nasdaq is already in bear market territory with a peak-to-through of -23% since November 19th, 2021, through end of April 30th, 2022. April was another month where value stocks strongly outperformed growth stocks, both in Europe as well as in the US. As if it was

not enough to have ongoing geo-political tensions along with more hawkish FED rhetoric's, China continues to apply its zero-Covid policy rigorously where it does not even refrain from imposing local shutdowns on its metropolises of Beijing and Shanghai. This not only weighs on global trade impacting the already fragile situation on the supply chains, but it will also put further pressure on inflation coming from the supply side. With the Chinese economy risking a breather in 2022 growth, not only did emerging markets equities also end the month of April sharply lower (5.5% MSCI EM Index), but some sectors in commodities also gave back all or most of their YTD gains, such as Copper, Silver and Platinum for example. Gold also came under pressure. More so due to a very strong USD. The USD index which measures the USD dollar strength vs a basket of other currencies had its best month since January 2015, up 4.7%. Most market movements of April can be explained by the upward shift of the interest rate expectations as priced-in by the FED fund futures (chart below). The target FED rate now stands at 2.7% by the end of the year. Higher FED rates mean higher yields, stronger USD, and outperformance value vs growth.

The stagflation scenario has now taken the upper hand following the publication of the US 1st quarter 2022 GDP. While expectations were for a modest gain of 1%, the real GDP figure came in as a contraction of the economy, shrinking by -1.4% on an annualized basis. The largest detraction came from net trade as exports posted their worst quarter since the second quarter 2020 while imports surged by 18%. The drag from net trade should not necessarily come as a surprise on the back of a strong USD since the beginning of the year. A positive spotlight was personal consumption which grew 2.7%, higher than the previous 2.5%, but lower than expectations at 3.5%. Nevertheless, the latest GDP figure undermines that we are indeed navigating through the late cycle with low growth and high inflation.



Source: Bloomberg / Banque Heritage

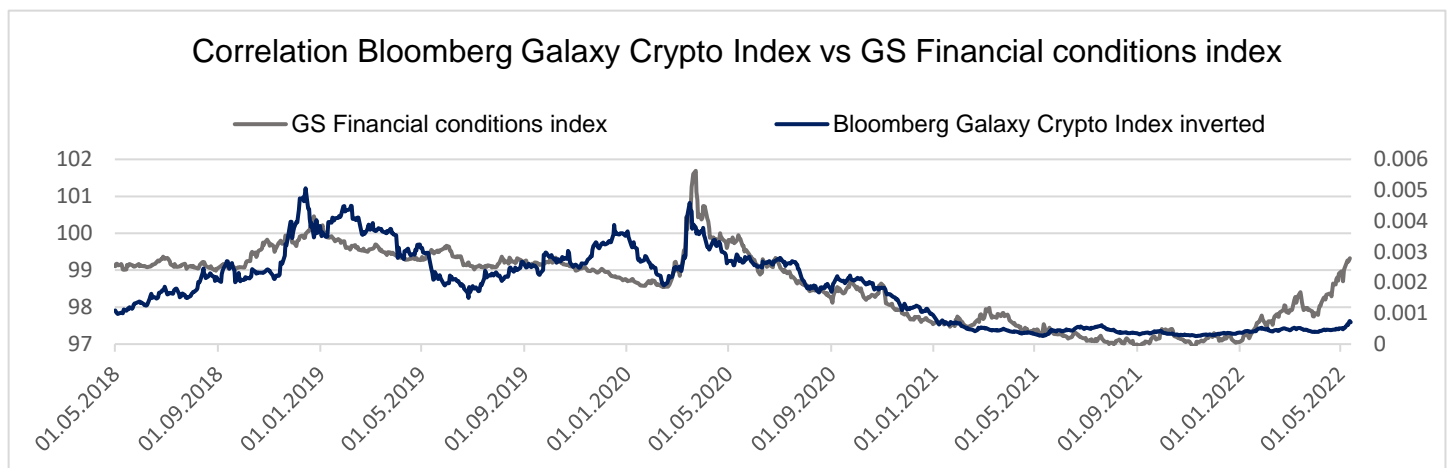


The first week of May was highlighted by the FED meeting with markets fearing that the FOMC would announce an aggressive 75bps hike to combat inflation. It settled for 50bps with the indication that 75bps are not necessarily considered for the remainder of the year which was initially well received by markets with a strong daily close on the S&P 500. However, the volatility we currently witness on financial markets is remarkable, as the strong gain was lost the next day without any meaningful additional news.

Hopes were high for the April 2022 headline US CPI to finally start descending from its multi-decade high in March 2022 from 8.5% with first inverse base-effects starting to kick in. Most importantly, the headline CPI came in at 8.3% lower than the previous month, albeit higher than expectations which were for a drop to 8.1%. The lower-than-expected drop was mostly due to a massive surge in airfares above expectations while the rest of the core services came in more in line with expectations. This reading did take some pressure off the FED, but future CPI readings will continue to be key for the acceleration in the tightening of financial conditions.

Corporate earnings have been very solid so far in the first earning season of the year. In the US, the beat ratio was 77% on over 90% of the companies that have already reported. Out of those 90%, over 80% have cited the word "inflation" during the investor conference calls. In Europe, the beat ratio was considerably higher on sales beats vs earnings beats, indicating that margins are indeed coming under pressure as well.

Clearly, the current economic backdrop continues to look challenging with several headwinds pointing to continued volatility in financial markets. The cryptocurrency market which had seen large inflows during its stellar year 2021 and become a mass attraction has now deflated considerably as well. As observed on the Bloomberg Galaxy Crypto Index, the current drawdown is -65% since its highs in November 2021. The below graph shows how tighter financial conditions impact the cryptocurrencies. As liquidity is drawn out and conditions become less favourable, the repricing on speculative assets which had seen enormous growth without any economic fundamentals.



Source: Bloomberg / Banque Heritage

Stagflation for the rest of 2022 is now our base case scenario. The negative US 1st quarter GDP reading further undermines this with considerable downside risk for a possible recession in the next 12-18 months. While the market has now priced in a considerable portion of the terminal fed rate, further upside risk on rates will depend on incoming inflation publications. Although base effect should further help ease those pressures, ongoing supply chain disruptions and the war in Ukraine might offset those base effects. In order to protect our portfolios against the recession scenario, we have bought long-term government bonds across all of our portfolios as these typically show more elasticity in global growth than short-term inflation expectations. Lower expected growth or at worst a recession should send long-term yields back lower. We also head into the summer with an important underweight in global equities while keeping our overweight in Gold and broad commodities. We have now cut to underweight one of the winners of 2022, the US dollar! Current positioning and the large move (parity against CHF reached, EUR/USD 1.035 on May 13th, 2022) have prompted us to take the profits in our CHF and EUR denominated accounts and hedge our USD exposure.

We wish you a great start into the summer!

Jean-Christophe Rochat, CIIA  
Chief Investment Officer

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