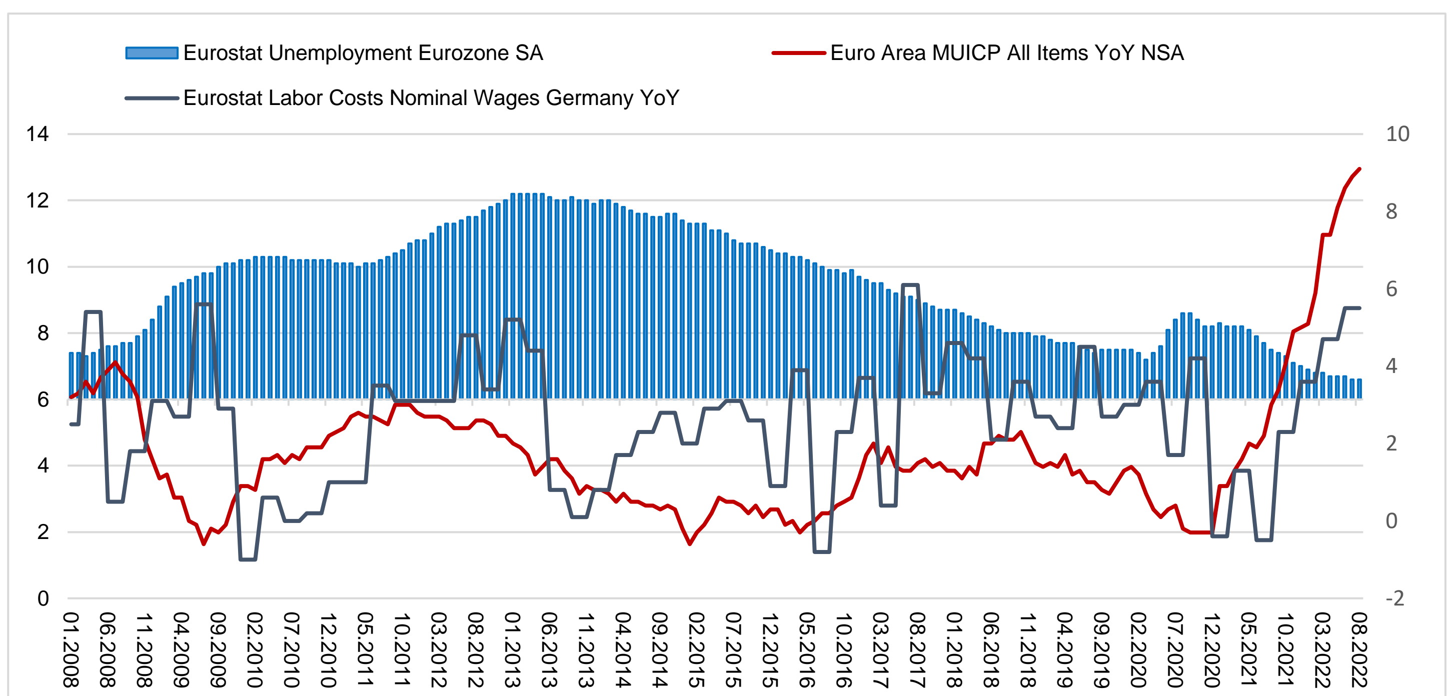
Letter from the CIO

October 2022

Volatile times to come

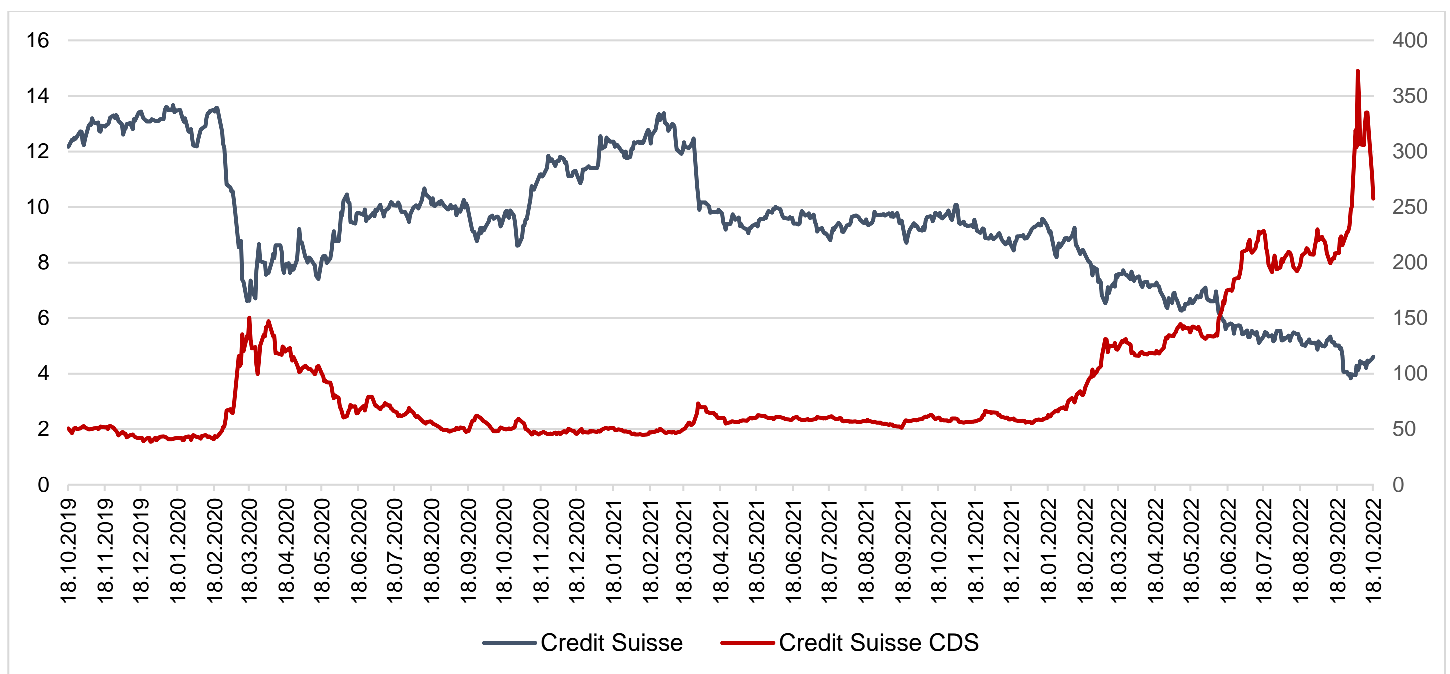
Not a month goes by without the markets surprising us! And September was no exception to this rule. Paced by the interventions of the main central banks to curb inflationary pressures, equity markets had a hard time digesting a worldwide rise in key interest rates of 50 basis points over the month. Central banks remain determined. Prices must come down, whatever it takes! Financing costs are rising, margins are eroding, and the spectre of recession is becoming ever so real. It is therefore no surprise that equity markets have quickly incorporated these latest developments into valuations, sending the indices of the world's major stock exchanges to levels equivalent to those of 2020. The US S&P500 index entered Bear territory last month, posting a decline of more than 20% since the beginning of the year and a drop of almost 8% over the month. This is the third consecutive quarter of decline for the index; we need to go back to 2009 to encounter the same phenomenon. The same is true for the European markets, with the Swiss SMI and European Stoxx 50 indices ending on a 6.7% decline. The coordinated interventions of central banks also weighed on bond returns, especially on the short end of the curve. For example, 2-year yields in the United States are now trading at 4.4%, i.e. 50 basis points above 10-year rates. We remember that the last 10 years were marked by the famous TINA ("There Is No Alternative"). We have to admit that this era seems to be over, and that the acronym TINA has given way to TARA ("There Are Reasonable Alternatives"). And while it is true that the bond asset class has become attractive again in a portfolio's overall allocation, the price investors have had to pay is substantial. The Bloomberg Global Aggregate Total Return Index in USD entered Bear territory for the first time in its history (creation in 1990) in 2022. This is unprecedented! On the commodities side, the RICI index was also under pressure in September, falling by more than 5%. Once again, it was energy that dictated the index's downward movement. The price of a barrel of Brent crude oil fell by 9% over the period. Despite OPEC's announcement in early September that it would cut oil production in an attempt to maintain prices, it is fear of a global recession that seems to be pulling prices down. Gold has lost further ground as well. A strong dollar and positive real rates in the US continue to weigh on the price of the yellow metal, despite persistent inflation and increasingly gloomy skies on the economic front.

The main macroeconomic figures published in the last few days do not point to an economic improvement. In the United States, consumer prices rose faster than expected during the month of September. The CPI index is up 0.4% after a 0.1% increase in August. Excluding food and energy, the core consumer price index rose 0.6% for the month and 6.6% year-over-year, the highest level since August 1982. There is no longer any doubt that inflationary pressures have spread to other economic areas. Paradoxically, the labour market is not helping! US companies hired more workers than expected in September, while the unemployment rate fell to 3.5%. With figures like these, the US labour market is close to full employment, leaving little room for doubt regarding a 75 basis point increase in the US in November. In Europe, while energy dependence on Russia has been the main trigger on the inflation front, price increases are not sparing other elements, such as wages, for the same reasons as in the US. The Eurozone economy grew by 0.8% in the second quarter of 2022, and unemployment has never been so low. We should therefore also expect a significant increase of the ECB's key interest rates at their next meeting in October. Some voices are even calling for a more aggressive response from Frankfurt. Last week, the head of Belgium's central bank made it clear that a rate hike to 3% by the end of the year would not be a surprise.



Source: Bloomberg / Banque Heritage

Everything therefore seems to point to a continuation of the monetary tightening cycle, which will perdure until the end of the year at least, unless exogenous factors thwart the plans of central bankers. The situation in England is one of those unexpected events that shows how fragile the current financial balance is, especially in the bond market, which has been drained by months of rate hikes. At the end of September, the announcement of a massive tax cut and stimulus spending program by the brand-new British Prime Minister Liz Truss took the markets by surprise. In response, British long-term debt rates rose rapidly, forcing the Bank of England to launch an emergency Treasury bond repurchase program to reassure the markets and, above all, to stabilize the many British pension funds holding these bonds, which are seeing a growing imbalance between their assets and their liabilities. Despite the manu militari dismissal last week of its finance minister Kwasi Kwarteng, the market remains under pressure. The yield on British 10-year bonds was trading at 4.3% at the end of last week, 30 basis points lower than its high of 2008! Another event on the credit market this time: the tensions at Credit Suisse. After the numerous scandals that tainted the reputation and health of the Swiss group, its stock price fell, literally making CDSs on the name explode. The market is obviously thinking of Lehman Brothers in 2008! However, if it is true that CS needs to restructure and probably strengthen its capital, we are far from the situation of 2008, thanks to the various regulations put in place regarding capital after the Global Financial Crisis. Is CS an investment opportunity right now? Not sure, but to think that it could go bankrupt...?



Source: Bloomberg / Banque Heritage

As we have seen, this is not the time to redeploy risk in portfolios. It is of course possible that a technical rebound will appear in the next few weeks, which could be generated by signs of easing inflation, or by better-than-expected earnings releases. Last week, 35 S&P500 companies released their numbers, including the major banks. Although it is a bit early to draw conclusions, the trend shows a slow but gradual reduction in earnings, while revenues seem to be stable.

The last quarter is often characterized by higher seasonal volatility, and the environment in which we are navigating this year is not conducive to a reversal of the trend. Caution is therefore still the order of the day!

Jean-Christophe Rochat, CIIA
Chief Investment Officer

www.heritage.ch