OBSERVATION

4th QUARTER 2022

THE (LONG) WAIT FOR THE FED-PIVOT

Investors need to show patience as a downward trend in inflation is necessary before risk assets can emerge into a sustained rally.

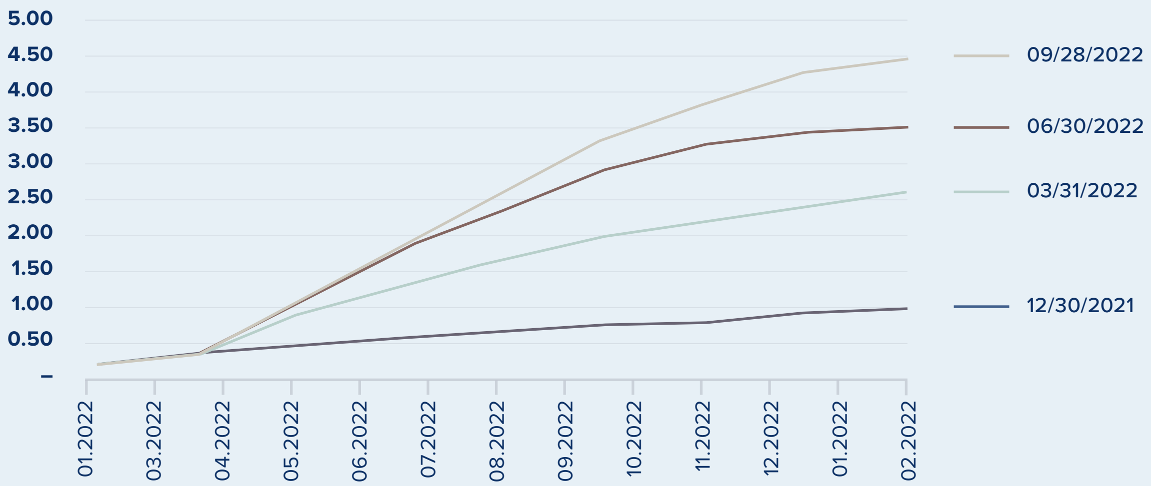
Waiting for Godot is a famous play written by Samuel Beckett in which two characters engage in a variety of discussions while awaiting for the titular Godot, who actually never arrives.

This rather tragical comedy painfully reminds us how the main actors on financial markets, equities and bonds have been waiting on the famous FED-Pivot. This moment has not yet arrived and constantly been pushed forward by persistently strong inflation numbers. While it is nothing unusual to see equity markets go into bear territory in light of expected recessions, the bond market has also given in, entering its first bear market, ever. The combining drop in prices of both main asset classes has left investors with little places to hide elsewhere and multi-asset portfolios with considerable YTD losses by the end of September 2022. The famous saying of «Don't fight the FED» has proven again its solidity this year. Courageous investors hoping to meet «Godot» aka the FED-Pivot were smashed at multiple occasions this year.

Within a year, the FED chairman went from downplaying inflationary forces as being «transitory» to «we need to bring inflation down. I wish there were a painless way to do that. But there isn't».

The odds are clear: Without economic pain, no gain. Without lower inflation, no FED-pivot. The below graph indicates the various rate hike projections of Fed Fund futures constantly moving to higher levels as the year went along. In between, we have seen various attempts by financial markets to challenge the FED to hit the brakes which were however followed by disappointments. While the first six months in the equity markets were mainly characterized by a compression in price earnings multiples leading them to being fairly priced when looking at long-term averages, our base case sees further volatility ahead through lower earnings expectations. Looking at past recession periods, there is further potential to go lower. While inflationary forces were first observed from the

FED Funds in USD



supply side and predominantly in the goods sector, they have now migrated into services and shelter which tend to be much tougher to bring down. The current imbalance of greater demand than supply in the job market is still paying its toll due to the COVID-19 crisis. For currently 11.2 million open jobs, there are 6 million active job searchers. It will be inevitably for the FED to see a higher US unemployment sector, currently forecasted to go up from 3.8 % to 4.4 % by 2023. Historically, such a rise has always led the US economy into a recession. In addition, investors should prepare themselves for revisions in earnings for the quarters ahead even though some have already priced-in to a certain extent a future recession.

The US consumer will play a pivotal role between a soft landing and a deeper recession.

While US average gasoline prices have come down over 20 % from their summer highs and offer a respite of breath to the US consumer, housing costs in terms of mortgages have skyrocketed to levels above 6.8 % (28/09/2022) last observed in early 2002. In Europe, the ongoing war in Ukraine lost some its focus since the beginning of the summer would it not have been for diminishing gas supplies from Russia. In what had initially started as an oil crisis has actually led into a gas and consequently into an electricity crisis. Even though Europe was able to fill its gas storage reserves recently, it will be doubtful that a throttled 20 % capacity supply of gas from Russia will be enough, especially if winter will be rude. From a price/earnings perspective, European equities are already trading in recession mode. However, further drops could materialize in case energy and electricity is rationed.

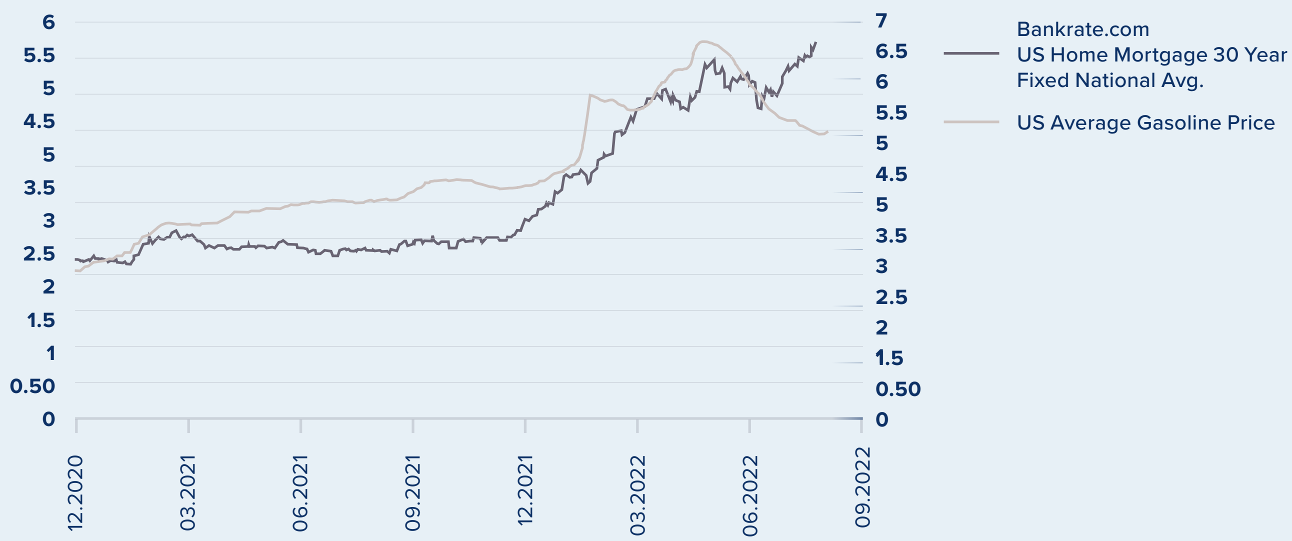
To the contrary of the US, we do not yet observe breakeven rates in Europe hitting a top, very much linked to the energy situation.

China could again be identified as the elephant in the room. In particular due to the ongoing woes of its real estate sector which contributes most importantly to Chinese GDP. The Chinese real estate market constitutes by far the biggest asset class from its sheer size of an estimated USD 62 trillion and of which USD 11 trillion are currently categorized as inventory. It will be instrumental to see if any changes to China's zero-covid policy will be acted in this month's 20th National Congress of China's Communist party. Rising protectionism and its consequences on global trade along with a very strong US dollar will continue to play a major role in emerging market countries, along with geo-political tensions over Taiwan more particularly for China. While the economic and political backdrop will continue to stay challenging in the quarters ahead, we believe that portfolios should stay invested in a diversified and conservative manner taking into account this very low growth or even recessionary-like environment. Volatility goes in both directions and completely stepping out of the market risks of missing out on fast and important rebounds as seen during the month of July. Consequently, we prefer to stay invested in defensive names with tilts into value and income generating equities. Decorrelated strategies can still be found and every contraction in asset prices offers new opportunities to be found, most evidently in fixed asset paying instruments.

The key question will be if the FED can bring down inflation without sending its economy into a deep slowdown and try to orchestrate a soft landing at best of temporary nature.

We position our portfolios to navigate through volatile times as the severity of the recession is difficult to foresee at this stage. The wait for «Godot», continues probably well into the end of 2022.

Consumer Cost in USD



Sources: Bloomberg

THE END OF AN ERA, WHAT'S NEXT FOR RATES AND THE USD?

The outlook for fixed income investors looks brighter, at the expense of mark-to-market losses in the existing fixed income portfolio..

Recent joiners into the financial world have experienced a new phenomenon in Europe and Switzerland: The end of negative interest rates!

Over eight long years of negative interest rates in Europe and over seven years in Swiss francs have put an end to the financial repression, something we had outlined to happen in our previous observation deck.

The lower image on the right page illustrates again how the higher rate environment has shaped the fixed income landscape. Negative-yielding debt seems to belong to a past chapter, the question «arises» (no pun intended) for how long? This move however does not come without some collateral damage in form of the first ever bear market (-20%), as seen on the Bloomberg Global Aggregate Total Return Index in USD) in history (since inception of index 1990), something that was up until now reserved for equity markets. The upward shift was however, predominantly driven by higher rates and not wider spreads. The latter have only started recently since the end of the summer to trade about 50 bps wider within the investment grade segment, on both sides of the Atlantic. It took without a doubt, lower earnings expectations, and higher financing costs to gradually drive-up investment grade spreads. Rising inflation and higher rates coupled with recession fears and geo-political tensions have weighted heavily on emerging market bonds and high yield, both a riskier segment within fixed income. Challenges will remain in this asset class and some segments still look prone for continued volatility. However, some unloved places, such as quality and short-term bonds start to look attractive, given the lower downside risks.

Volatility was not only high on equities and fixed income markets so far in 2022. FX volatility has also been present at levels not seen since 2020 at the height of the sanitary crissis.

However, to the difference that the spike was sudden and also short lived in March 2020 as per the below illustration, there is a clear trend in the 2022 observed data (Deutsche Bank Currency volatility index). The dollar strength has been extraordinary this year driven by a higher rates environment in the US while taking advantage of its safe haven asset. The FED has just started during September to double the monthly pace of its balance sheet reduction to USD 95 billion of FED balance sheet. Both dollar strength indicators have moved in tandem this year which also led to tightening financial conditions outside the US as well. Obviously, the US dollar strength is one side of the story, but downward pressures on the EUR (structural?) and the GBP (mostly political) as well as the YEN (yield curve control) surely contributed their part as well. But the US dollar has also appreciated vs. safe haven currencies such as CHF.

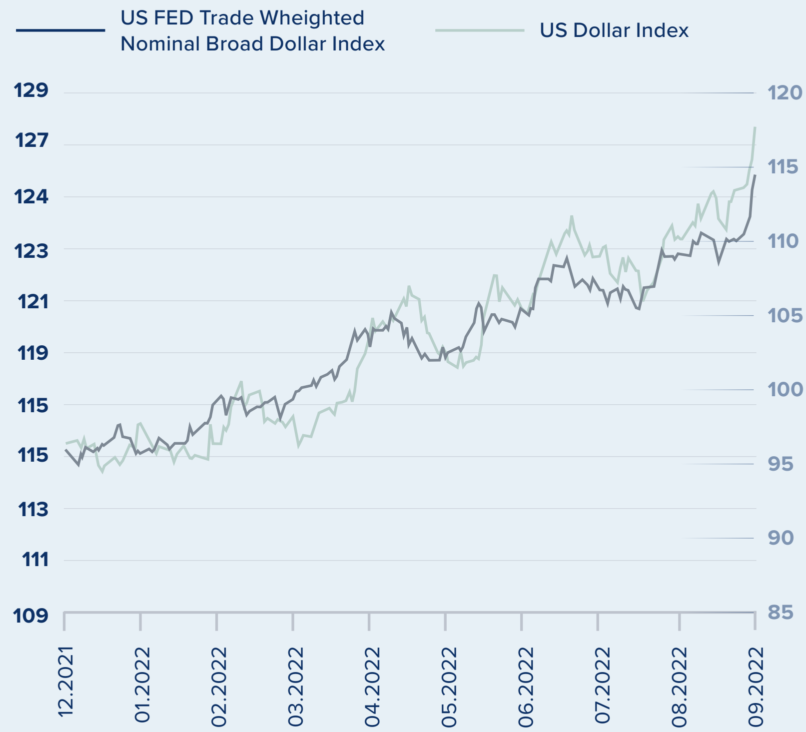
While monetary authorities monitor against unwanted appreciation of their currencies closely to keep exports appealing, currency strength also helps to contain imported inflation. Best-in class example is Switzerland which withstands better against the inflationary forces thanks to a strong CHF.

But a strong dollar is a major headwind to global growth. In what was over 30 years ago entitled as the «Plaza accord», where the US, the UK, France, West Germany and Japan signed a joint-agreement to depreciate the US dollar in relation to the other currencies by intervening in the currency markets. And it worked! The USD depreciated significantly until it was replaced by the «Louvre Accord». In anticipation of the G20 summit, which will take place in Bali in November 2022, hopes by countries aching under the strong US dollar will have little chance to be materialized. To the difference of 1985, inflation is much higher in the US today and the US has a current interest to focus on «America First», even during the Biden administration. The USD strength Is tempting to take profits.

But as goes the saying for equities also goes for the US dollar: «Don't fight the FED». As long as the FED keeps up its fight to bring down inflation, coupled with US dollar withdrawals through balance sheet reductions, we should see the US dollar well bid.

Negative yielding debt in USD

US Dollar



Sources: Bloomberg

WHEN BONDS SLAP YOU, TURN THE OTHER CHEEK

Things will get tougher before they get better. Investment grade bonds may hold the key.

As discussed in our previous segment, the move observed in fixed income since the beginning of the year is unprecedented.

Traditionally regarded as the safe portion of any soundly allocated portfolio, bonds' unison downwards move with equities took investors by surprise.

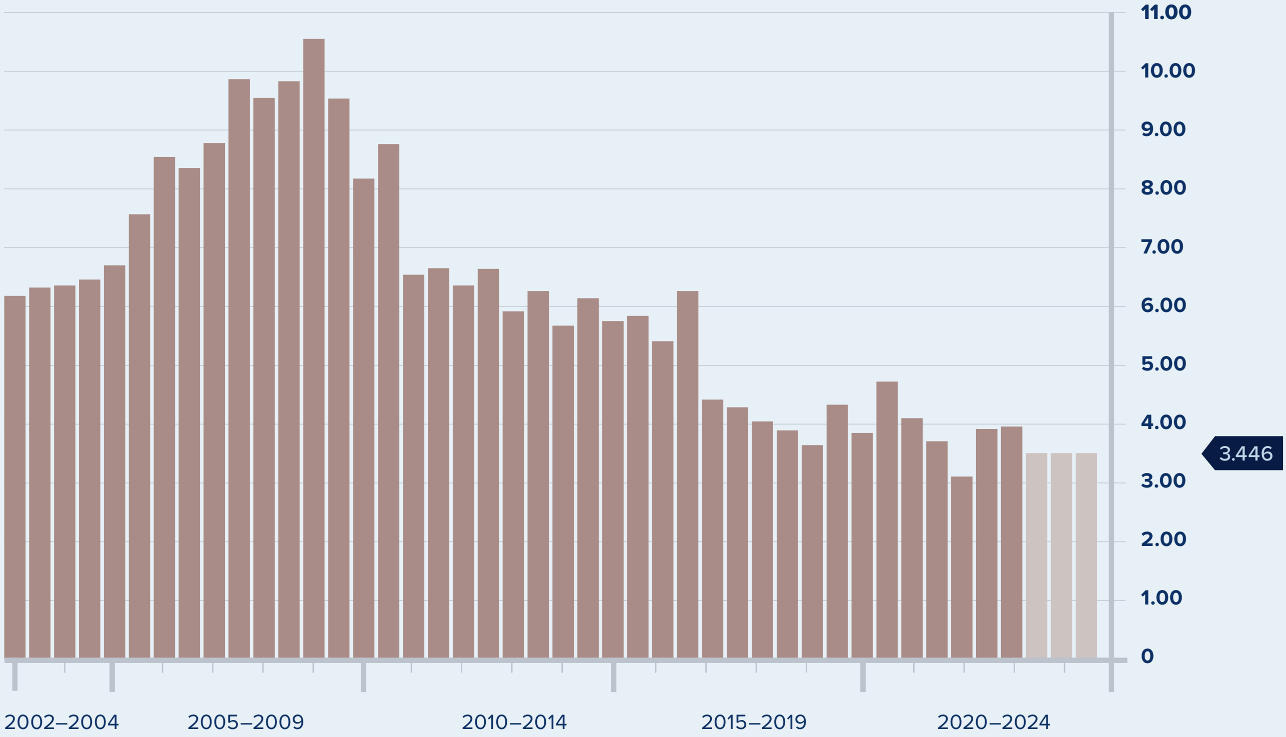
This threw traditional asset allocation models off-balance, with defensive profiles (usually holding a higher proportion of fixed income) doing as poorly, if not sometimes worst, as balanced portfolios.

The conditions of this perfect storm have been brewing for some time:

Unprecedented financial repression is followed by rampant inflation, increasing interest rates, and ultimately widespread impact on the investment grade markets due to duration sensitivity as well as the high yield market due to default rates' increases.

However, what sets apart this crisis is twofold. Firstly, there is nowhere to hide, as all major economies are facing the same issue. Secondly, it is the depth and breadth of the investment grade market's move. With yields standing globally at all-time lows, and coupon levels virtually null, the cushion usually available to sustain some of the rates increase impact on bond prices simply was not there.

Companies remain healthy
SXXE Index



Date: 7th of July 2022

Source: Bloomberg

In a context of structurally higher inflation, higher expected terminal rates and economic uncertainty, what can investors do?

The answer probably lies within the problem: more fixed income. Contrarily to equities which can fluctuate in value and remain depressed for sustained periods, bonds, unless they default, always converge back to par, their issue price, at maturity.

Furthermore, companies remain healthy, with a number of them still able to pass on cost increases and relatively low debt levels (see chart). With a current average yield of 2.5–3 % for the next two years and close to 5–6 % for the next 5 years in Europe, investment grade bonds represent a compelling opportunity to rebuild stability and visibility in portfolios. This is something investors were unable to do over the past ten years, period during which bonds were solely utilized for the purpose of diversification. While the high yield market remains off boundaries for as long as the rates trajectory is not final and the depth of recession unclear, investment grade bonds from high quality issuers with low cyclical exposure should be scouted and purchased, with the prospect of further building exposure on weakness.

On the one hand, it is tempting to remain divested in hope of a relief and to recoup losses by allocating to equities once the dust settles. But this option comes at a substantial cost, that of inflation. We further believe that this time has not yet come. On the other hand, the opportunity to rebuild a sound fixed income exposure and to lock-in comfortable returns for the medium term, which should allow to battle medium inflation expectations, may not represent itself.

Besides, one should not dismiss the probability that central bank policies will send economies in a painful recession sooner rather than later, thus calling for a policy pivot and a strong «elastic effect» on bond prices.

In this scenario, 5y bonds could very well provide a high single digit return in the next year or two.

MISSION

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