BANQUE HERITAGE

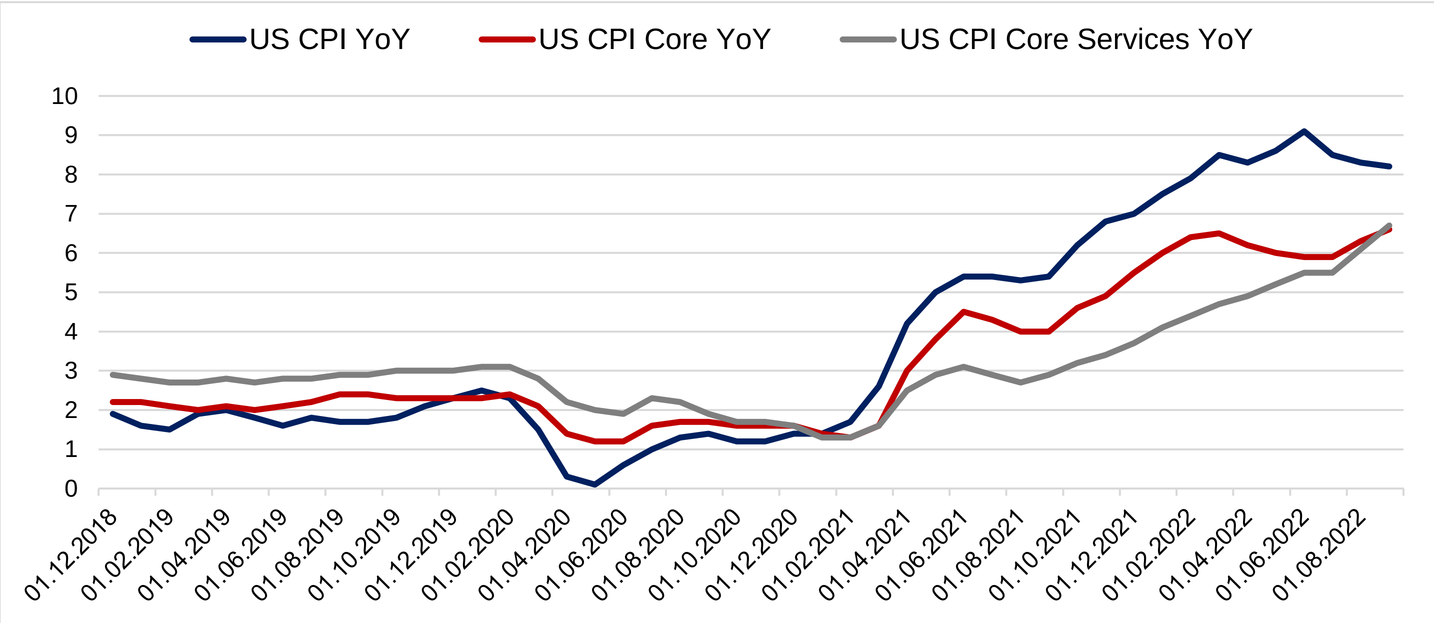
Letter from the CIO

November 2022

Mid-terms, Thanksgiving and Black-Friday!

The month of October was by no means less interesting than the previous month although not as many central banks proceeded to further rate hikes. It was, however, a bumpy road eventually ending on a more positive note, in particular for developed equity markets, which had not been the case much in 2022 so far. Inflation continued to be the key driver for higher yields with the US 10y Treasury ending the month 20bps higher than at the beginning at 4.05% with most of the yield curve in deep inversion territory, e.g., the 2/10Y spread at a negative 43bps. The third quarter earnings season started to gather attention as well from the second half of October onwards, with 85% of the companies in the S&P 500 having reported by November 4th, 2022. This gives us a good insight on how higher costs continue to impact earnings and on the outlook for the months ahead which we will focus on at a later stage. Bear markets can give birth to extreme erratic market moves such as the one witnessed on October 13th this year, the day US CPI numbers were published which disappointed heavily. The S&P 500 index briefly touched a YTD low on the same day at 3491 points with future contracts on the index loosing over 3% within a very short timeframe but rallying over 5% intra-day for the index to close at 3669. Value was again the key driver behind the S&P 500 October monthly return of +8.1% outperforming the tech-loaded Nasdaq (+3.9%) and pushed by the top performers in energy (+24.4%), financials (+12.2%) and industrials (+12.8%). The pattern was similar on the other side of the Atlantic with the EuroStoxx 50 rising +9.1% with the same energy and industrial sectors outperforming the others. In equity markets, emerging markets had a hard time keeping up with developed markets. The MSCI Emerging market equity index finished October with a negative -3.1% dragged by a -14.7% fall in Hong Kong listed shares. The Chinese 20th party congress, with president Xi confirmed, disappointed those who expected some easing regarding China's Zero-covid policy, while service sectors in the country were still suffering from local shutdowns. China's inflation remains lower than in most other countries at 2.8% YoY which allows the PBOC to pursue accommodative monetary measures to support its economy. Other erratic moves were to be found in Europe. UK's newly elected prime minister Liz Truss resigned from office with a record low tenure of 49 days from September 6th to October 25th, beating the second shortest tenure held by George Canning, who died in office after 119 days on August 8th, 1827. The poorly elaborated tax-cut plans by Truss's office continued to dislocate the UK bond market with yields flying and the pound tumbling across extreme volatilities. Rishi Sunak's appointment as new prime minister brought some relief, both on the UK government bond yields and on the sterling, after reversing many of the previously announced tax cuts.

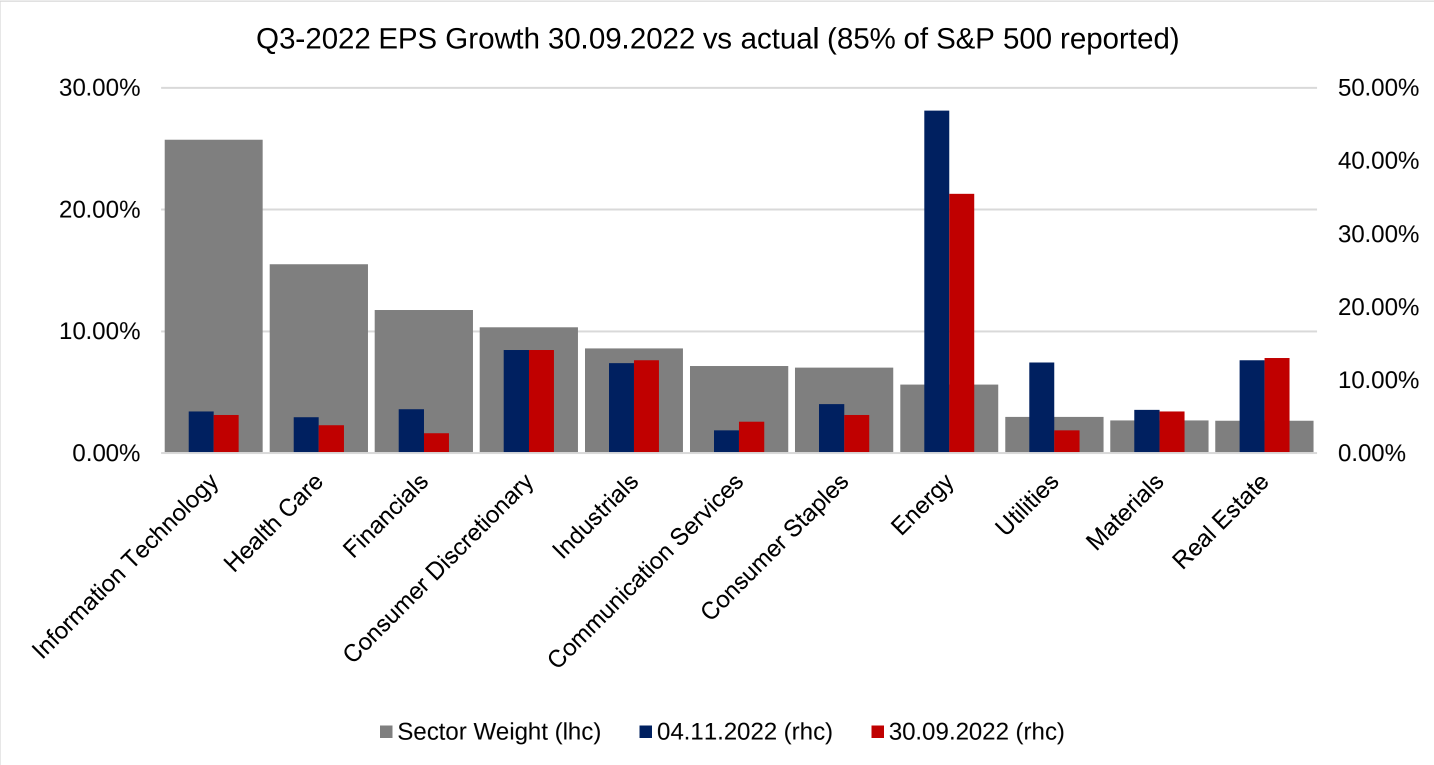
The latest macro-economic developments and published figures continue to point to a slowdown in economic activity. The much-awaited Q3-2022 GDP in the US exceeded its promise with an annualized growth of 2.6% in the third quarter, above expectations of 2.4%. Leading indicators such as global US composite PMI still indicate a contraction of the economy at a level of 48.2 in the October data. Another aggregate of leading indicators is the Conference Board of US leading Indicators index which considers a total of 10 components, and which continues to undermine the slowdown in economic activity. Even though on the inflationary front headline CPI has continued to come down from its previous peak of 9.1% in June 2022 to 8.2% in September, the market's attention has turned to core inflation which excludes volatile components of energy and food even though they only make up 20% of the headline CPI. Indeed, inflation continued to creep up in core elements such as housing costs and servicing costs. And the FED showed its dislike with its latest 4th in a row 75bps rate hike, explaining that the incoming data since the September meeting suggests that the ultimate level of policy rates will be higher than previously anticipated. With the labour market continuing to be out of balance with much more open jobs than actively looking workers, FED chairman Powell made it clear that it was very premature to think about pausing policy rate hikes.



Source: Bloomberg / Banque Heritage

There are currently two developments which can impact the direction of equity markets: Earnings estimates and P/E multiples. The latter has already contracted significantly over the course of 2022 from over 21x NTM earnings for the S&P 500 at the beginning of the year to currently 16.5x. Current earnings estimates have not seen a drop to the same extent and hence are not entirely discounting the fact that future earnings expectations have further potential to be downgraded or even to go into contraction mode with the global recession scenario still prevailing. The much-awaited Q3-2022 earnings season has not lived up to its promise of 2.7% EPS growth (expectation beginning of October) over the same period ending Q3-2021 as the current number sits at 2.2% YoY Q3-2022. The headline number does not indicate a recession in earnings and is rather supportive for the rally witnessed in October. However, some elements seen in the current earnings season clearly support that the slowdown is also taking place in earnings. On a year-over-year basis, the S&P 500 is reporting its lowest earnings growth since Q3-2020. Especially, the FAANG which had been constant support of markets in past times have surprised with difficulties this past quarter. With Apple as the exception (+7.4% following earnings announcement), Alphabet (-10.2%), Microsoft (-8.8%) and Meta Platforms (-24%) have deeply disappointed with their reported numbers. We stay cautious for the outlook in the quarter ahead sharing the opinion that further earnings downgrades could take place.

The second event that is catching much attention are the mid-term elections in the US with the entire lower house being re-elected (435 seats) and a third of the senate. Had the republicans gained control of both chambers it would have made it difficult for President Biden to bring through reforms. Apparently, this has been averted. Generally, mid-term years are not necessarily a bad omen for equity markets. In the past 19 mid-term cycles after WWII, the S&P500 always ended up higher over the next 12 months. The odds are obviously very different in the current cycle with a 40Y high inflation and a rapid policy rate tightening pace by the FED. However, political stalemates between parties have also historically favoured sectors that are rather frightful for regulatory reforms such as the financial and energy sectors which we continue to like even though we have recently taken profits on energy names.



Source: Bloomberg / Banque Heritage

The end of the year is near but will continue to be challenging and require investors to stay attentive and reactive. We continue to hold an underweight in equities, predominantly in emerging markets. We favour quality low growth names with a tilt on the healthcare sectors. Our gold positions have suffered amidst a higher real yield environment and a strong US dollar but ought to fare well should long-term yields start to price in higher recession probabilities.

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