Letter from the CIO

BANQUE HERITAGE

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The end of "free money"

2022 is coming to an end and unless we see either a major drop in global yields and/or more than an impressive Santa Claus rally, both the S&P 500 and aggregate bond indices will be posting negative returns for the first time since…1969 (!) and before that in 1931! 2022 has been exceptional to say the least when realizing that this is only the third time in 100 years with simultaneously negative returns in stocks and bonds. Who could be the culprit? Resurging inflation and a rapidly changing rhetoric by the FED, followed by the most aggressive policy rate hikes in decades, sent global yields to levels not seen in a long time, officially putting an end to the financial repression and the negative and zero interest rate environment.

As of the time of writing, the S&P 500 is down -19.85% whereas the technology loaded Nasdaq is losing -32.57%. The underperformance of the latter puts into perspective how the higher yield environment was predominantly driven by a contraction of earnings multiples as witnessed for the S&P 500 coming down from just below 23 times its next 12 months earnings to its longer-term average of 16.6 times its future 12M earnings. Value oriented markets or cheaply valued stocks fared much better through this "repricing" than high growth equities. The MSCI USA Growth index is currently underperforming the MSCI USA Value index by a large margin, losing -32% while value is only down -8%. In Europe, defensive stocks are even up +5.5% while cyclicals are down by -17.5%. The difference in sector returns could not have been more impressive. While the energy sector in the US has risen 57.47% in 2022, the communication sector has devalued by -42%. As a result, commodity and value led equity indices such as the UK's FTSE 100 (+3.2%) and the Brazilian Bovespa (+0%) have fared much better than growth sensitive equity indices.

The FED has been leading the rest of the world through its aggressive front-loading of policy rates as it was quickly evident that only a general slowdown in economic activity would bring down the highest observed inflation of the last 40 years, with the US CPI so far peaking at 9.1% YoY in June 2022. One winner up to now has been the US Dollar which had crossed parity vs the Euro hitting as high as 0.9536 in September 2022. The rest of the world and in particular emerging markets were aching under the pressure of the strong USD which acts as a natural tightener globally. An elephant in the room can be identified as Russia's invasion of Ukraine. The resulting geo-political uncertainty added to inflationary pressures but was however able to support the gold price which was already under heavy pressure to a strong USD. Higher real rates weighed on gold for the second and third quarter with the ounce trading as high as USD 1'614. Many investors were left rather puzzled on how gold was not providing much support when the observed inflation was at multi-decade highs. The relevant explanation can be found by looking at future inflation expectations which have started to come down since the end of March 2022, at least in the US.

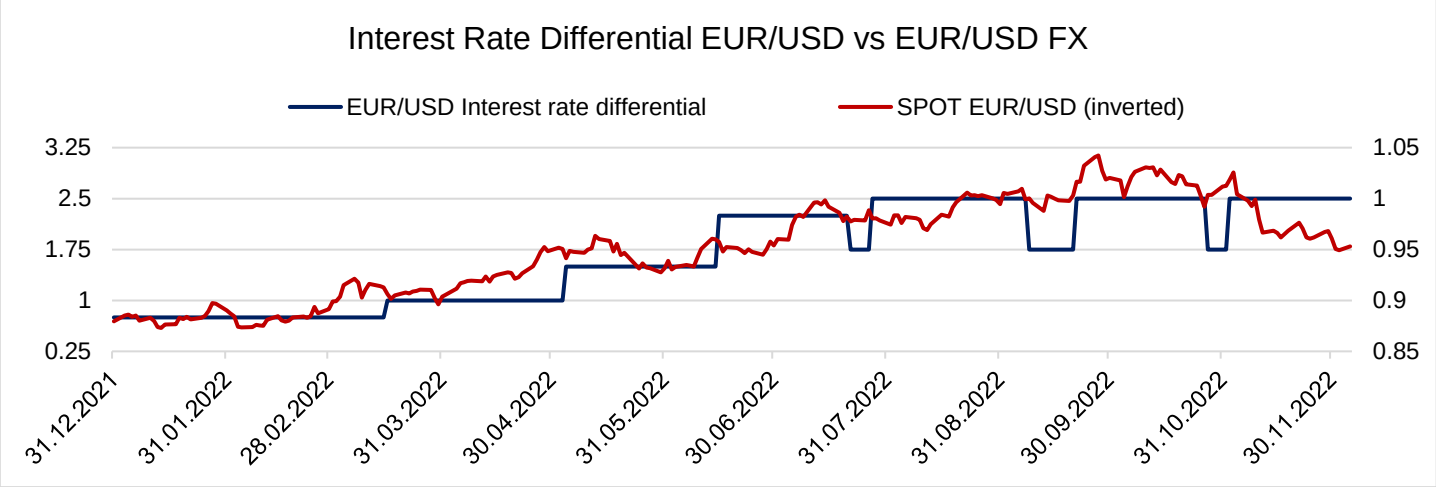
The market does believe that the FED will be able to bring down inflation through its aggressive interest rate hikes. The drawdown witnessed so far is also very impressive as conservative portfolios have suffered just as badly as more aggressive ones. In some local markets, equity indices are outperforming fixed income indices, such as in Europe. Whereas the Stoxx 600 is currently losing -9.7%, European investment grade bonds are down -14.5%. The picture is similar in Switzerland and not too different in the US. The lack of outperforming alternatives was very difficult to find as traditional cross-asset correlations were challenged throughout 2022.

Next year will be another challenging one for the financial markets. They will have to navigate with high inflation, very restrictive monetary policies, and economic growth that will enter a recession in some geographical areas. While it is difficult to predict the evolution of financial asset prices in such an environment, we have some strong convictions that we would like to share with you.

USD

After inflation seems to have peaked the last few weeks, it should continue to fall during 2023 in the US. The FED has already slowed down the pace of rate hikes at its December meeting. Coupled with a pronounced economic slowdown expected in 2023, the US yield curve could invert even further over the coming months.

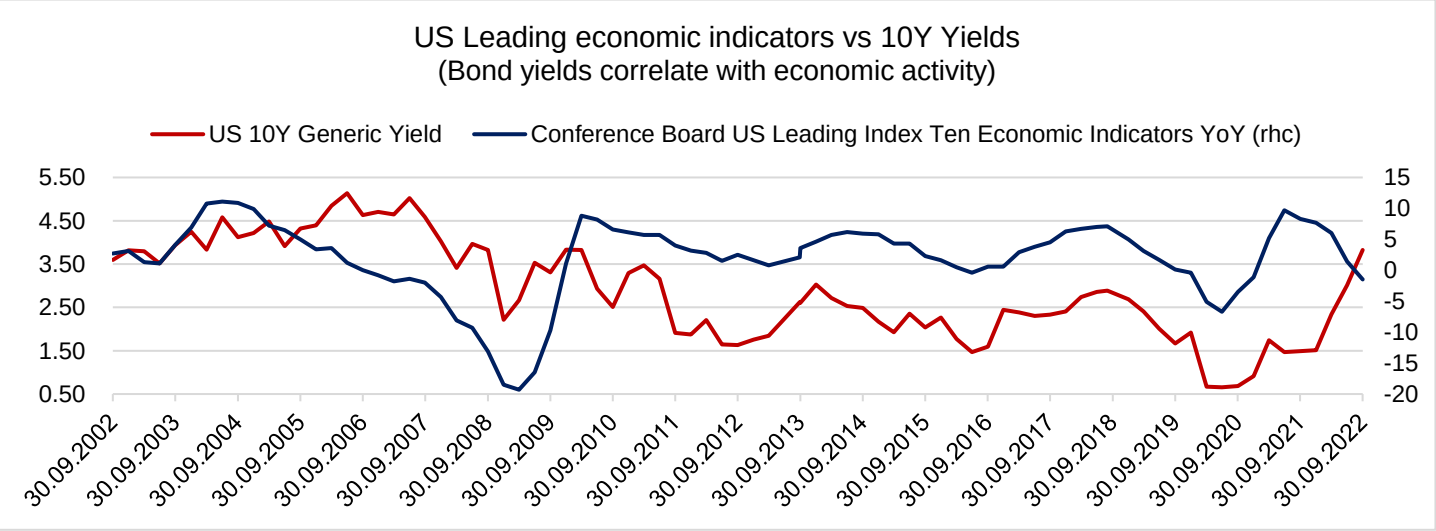
The Eurozone is facing higher headline inflation, especially due to energy and agricultural prices. We believe that the European Central Bank will accelerate its tightening policy, while the Fed is going to start a decelerating phase. The interest rate differential between the two currencies could therefore weaken in 2023, which is why we are underweighting the dollar against the euro.



Source: Bloomberg / Banque Heritage

FIXED INCOME

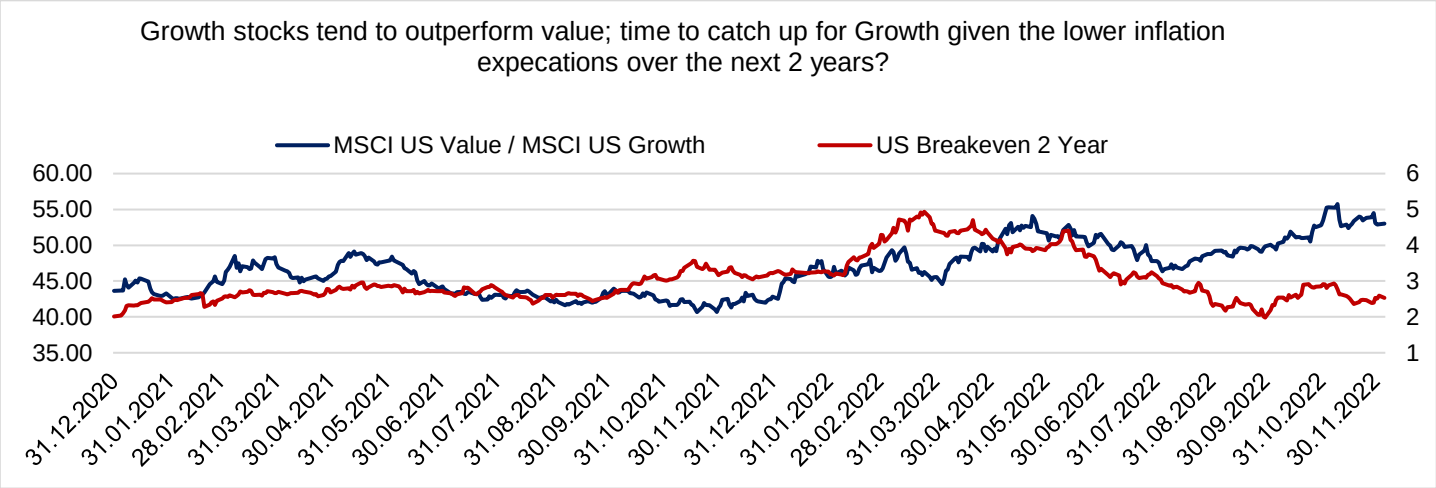
A higher duration in our portfolios will be a key element of our 2023 Fixed Income strategy. Disinflation pressure combined with a global economic slowdown should weigh on sovereign yield curves, first in the United States, then in Europe. A gradual repositioning along the curves, with the aim of anchoring our portfolios' duration in the belly, is an important part of our strategy. We will also gradually increase our duration on the credit side, while remaining positioned on quality names to be able to navigate serenely during a potential recession as default rates could tick up.



Source: Bloomberg / Banque Heritage

EQUITIES

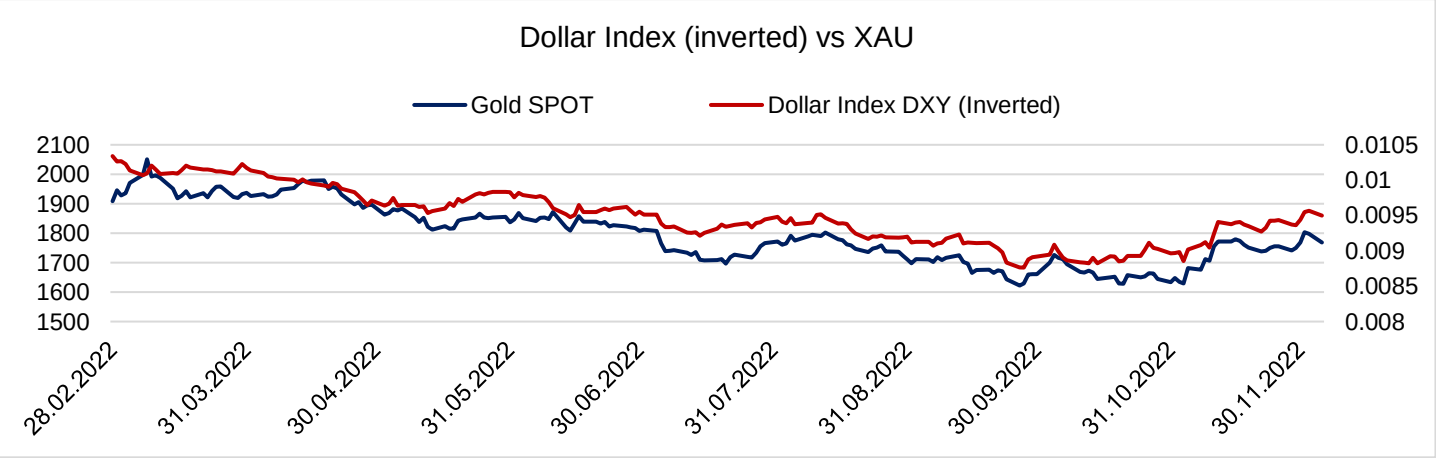
Recession and restrictive monetary policies will undoubtedly maintain a high level of volatility in the equity portfolio. Cost of financing, as well as the high cost of goods and services, should continue to impact both, corporate margins and household spending. We therefore remain cautious on expected equity market returns for 2023. We prefer to participate in the change of economic cycle by considering the implementation of a barbell strategy within our portfolios. Consequently, our very resilient sector allocation this year which was mainly focused on energy, healthcare, telecom and financial sectors, will be gradually complemented by more growth-oriented sectors such as consumer discretionary and technology companies. We should still keep an overall underweight positioning across all our profiles.



Source: Bloomberg / Banque Heritage

GOLD

Although everyone expected gold to be the bulwark against runaway inflation this year, the strong appreciation of the Dollar and the appearance of positive real rates in the US have not allowed the yellow metal to shine. In our view, the conditions described before are changing and supportive for the precious metal. We therefore believe that 2023 will be a different year for gold! We remain overweight!



Quelle: Bloomberg / Banque Heritage

Happy Holidays to all of you and see you next year!

Jean-Christophe Rochat, CIIA
Chief Investment Officer

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