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HERITAGE.CH

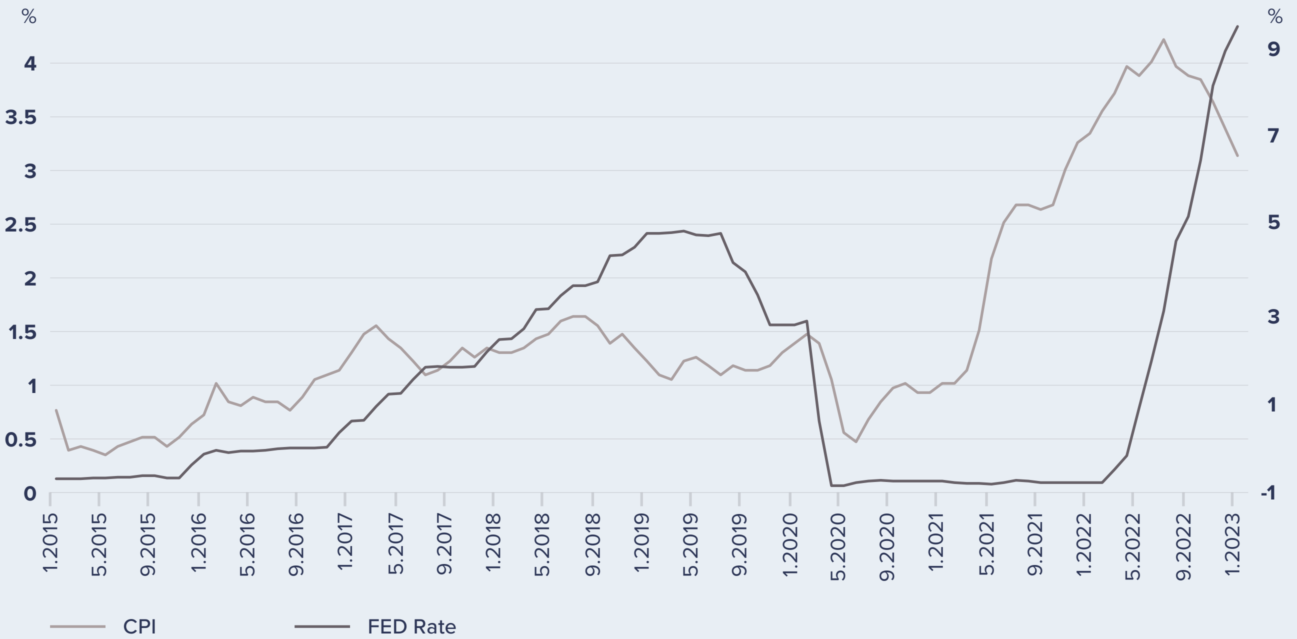
A BREATH OF OPTIMISM!

The worst is probably behind us and markets have already anticipated it. But vigilance is still a must!

While Switzerland has just emerged from a stormy episode characterised by icy wind chills and the arrival of the long-awaited snow on our peaks, the start of the year has been much milder for the financial markets.

For a few weeks now, investors have been feeling a warm breeze of optimism after a year that could be compared to the winter of 1962–1963 in Europe, one of the harshest winters since meteorological records began. Inflation, growth, monetary policy… so many variables that last year created a storm on the financial markets, but also caused them to recover massively in recent weeks. While it is true that the economic environment remains worrying and that the current management of monetary policy can be likened to a balancing act, a number of macroeconomic data published in January allow us to see a glass that is finally… half full! In the United States, the first estimate of fourth-quarter GDP showed that the US economy had held up better than expected, despite stubborn inflation and steadily rising interest rates. On an annualised basis, the economy grew by 2.9 %, compared with the consensus forecast of 2.6 %. However, this figure should be tempered by the fact that a sharp rise in inventories boosted growth in the quarter, a trend that should reverse in the coming months. Inflation figures were also good news, as the slowdown seems to have been confirmed. The consumer price index fell by -0.1% in December 2022. And while this may seem like a small drop, it is the largest monthly decline since April 2020. Will this be enough to convince the FED to stop raising rates? Not in the immediate future, as Jerome Powell hiked rates by another 25 bps at the beginning of February, while signalling that more hikes could be on the way. But the market still reacted well. Why is that? Remember… the glass half full story! This quarter percentage point hike is a more normal level of increase after several very sharp 0.50 % or even 0.75 % hikes

FED Rate vs CPI



Date: 31st of January 2023 Source: Bloomberg

since the tightening began. Finally, US monetary policy appears to be normalising. Another boost came from Powell's speech, in which he said that the end of the tightening was near and, above all, that the FED did not want to tighten monetary conditions too much. The skies seem to be clearing, and investors like it very much, as evidenced by the volatility of the equity markets, which are currently hovering around their levels at the end of 2021.
The picture also looks slightly brighter in the Eurozone, with investment firms as Goldman Sachs now even expressing a growth forecast of +0.6 % for 2023, whereas they were still expecting a decline of -0.1% in December. And it is a meteorological phenomenon that partly explains this improvement. If winter is here, it arrived late this year, depriving many skiers of a snowy holiday. But as is often the case, one person's misfortune is another's fortune! This relatively mild first part of the winter enabled the euro area to avoid gas and electricity shortages. As a result, the currency bloc showed unexpected strength in the final quarter of 2022, posting higher-than-expected growth. However, there are still many challenges facing the Eurozone. Among them is inflation, which remains the European Central Bank's number one enemy.

Even though consumer prices eased for the third month in a row in January, the ECB has no intention of easing the pressure. It has just announced another 50bp hike in early February and has already confirmed a similar increase for March. Its policy is certainly hawkish, but it is necessary. The message is clear: the ECB is determined, and the effects of its policy are starting to be felt.

The reopening of the Chinese economy is also a tailwind for 2023. The rebound in Chinese activity could offset some of the global economic slowdown, particularly in Europe, and this is what drove European equity indices in January.

One obvious example: LVMH is currently surfing on all-time highs, above € 800 per share. The group continues to post impressive financial results and is set to benefit from the recovery of the Chinese economy in 2023! The IMF is also less pessimistic. The fall in energy costs and the reopening of China are the two main factors that have led the institution to raise its global growth forecasts for 2023 from +2.7 % to +2.9 % in annual terms.

As you will have understood, there is no euphoria, but the tone is more optimistic! And we share this view. The storm may be behind us, but there could still be some violent winds ahead.

That is why our portfolios are currently allocated in a way that allows us to navigate this febrile but promising environment. We remain convinced that an important part of the performance in 2023 will come from the bond pocket, which is why we have recently increased our exposure and duration in our sovereign and (investment grade) credit pockets. We have taken a more optimistic view on our equity portfolio by returning to our neutral position, while remaining invested in quality defensive sectors. Gold also appears to be an asset to focus on this year after a disappointing 2022. Supported by central bank buying in 2022, the gold price has risen almost 20 % since its last low in September to its highest level since … 1967. Let's hope that a weaker dollar and falling real interest rates will push the yellow metal even higher!

Gold Inverted vs Real Rates

Date: 9th of February 2023 Source: Bloomberg

WINTER ISN'T OVER, YET

Real market recovery or bear-market rally?

In 2022, global equity markets fell by 18 %, the worst performing year after 2008, 1974 and 2002. However, and to further extend the metaphor, the latter turned the thermostat to MAX since the beginning of the year, warming up a rather icy atmosphere beyond expectations, against a backdrop of significant drop in energy prices, a scheduled reopening in China and a perceptible slowdown in inflation data. So much so that after a month of stock market moves, many indices have already reached the levels expected by the majority of analysts and macro-economic research firms for the end of 2023! The S&P is back to its early 2021 levels, while the Stoxx 50 had its best start since 1987, beating (for once) the US market, while the SMI is back to its pre-covid step. The sectors that were most negatively affected in 2022, tech, communications and consumer discretionary, are making a strong comeback.

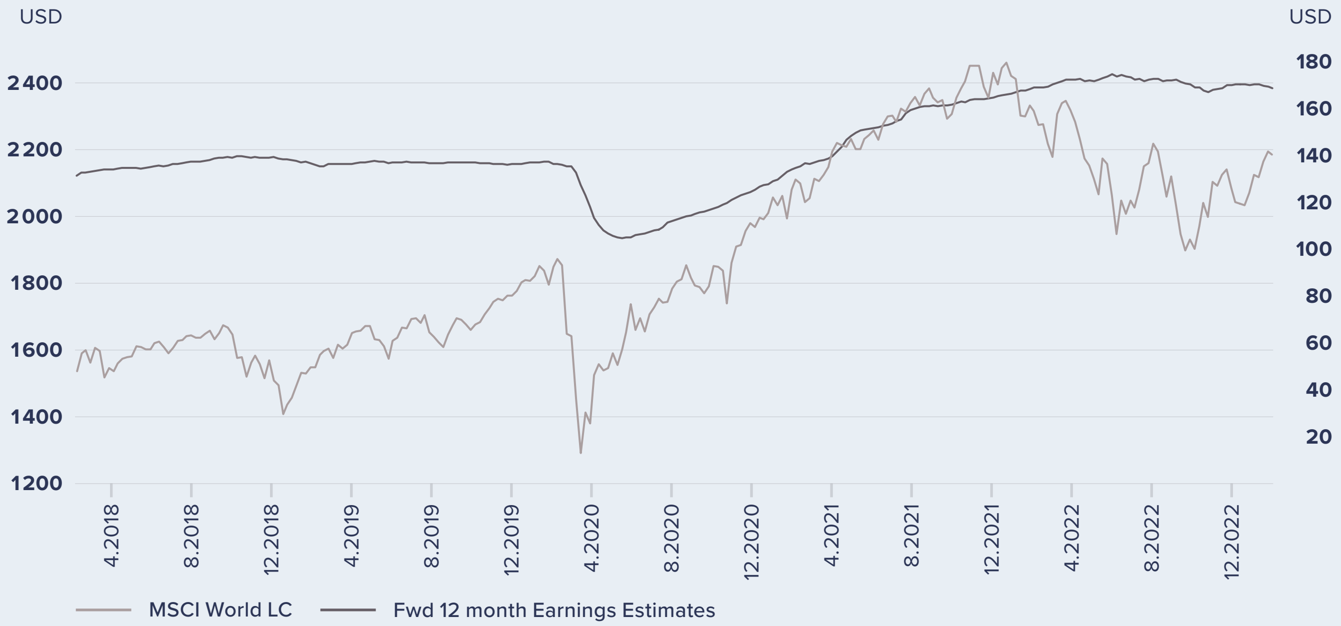
It will prove to be a difficult year to navigate, as no one anticipated such a recovery, and rightly so.

Indeed, it would be tempting to throw off one's winter clothes in anticipation of future monetary policy easing, especially since the main equity markets are trading slightly below or at their historical averages. But beware of the spring chill, as the combination of a sluggish or slightly negative global economy and an expected decline in earnings growth are both a historically unfavourable context for equities. In addition, the Ukraine conflict and the evolution of the relationship between the US and China are difficult to predict. It is likely that the substantial rally this early in the year is due to the theory that equity market lows traditionally occur before economic and earnings lows. Investors have also been accustomed to central banks being there to inject liquidity in such a scenario. But the experience of the past 15 years has not been particularly comfortable for central bank governors, so it may be that policy rates will remain at their peak for longer than expected.

In any case, and considering this thunderous start to the year, volatility could well return at the first sneeze.

We have adopted a more constructive bias in recent months and have repositioned our equity pocket to our neutral points. However, aware of the uncertainty, we maintain a defensive sector positioning, favouring healthcare and financials, as well as quality and high dividend strategies. We are also reconsidering emerging markets, favoured by the relative weakness of the dollar as well as by the visibility offered in China. Increased clarity on inflation, economic slowdown, and monetary policies will allow us to redeploy more risk in this pocket in the coming months.

MSCI World LC vs. Fwd 12 month Earnings Estimates



Date:10th of February 2023 Source: Bloomberg

DONT BE SCARED OF DURATION!

Fixed-income securities are becoming attractive again due to the big reset in 2022.

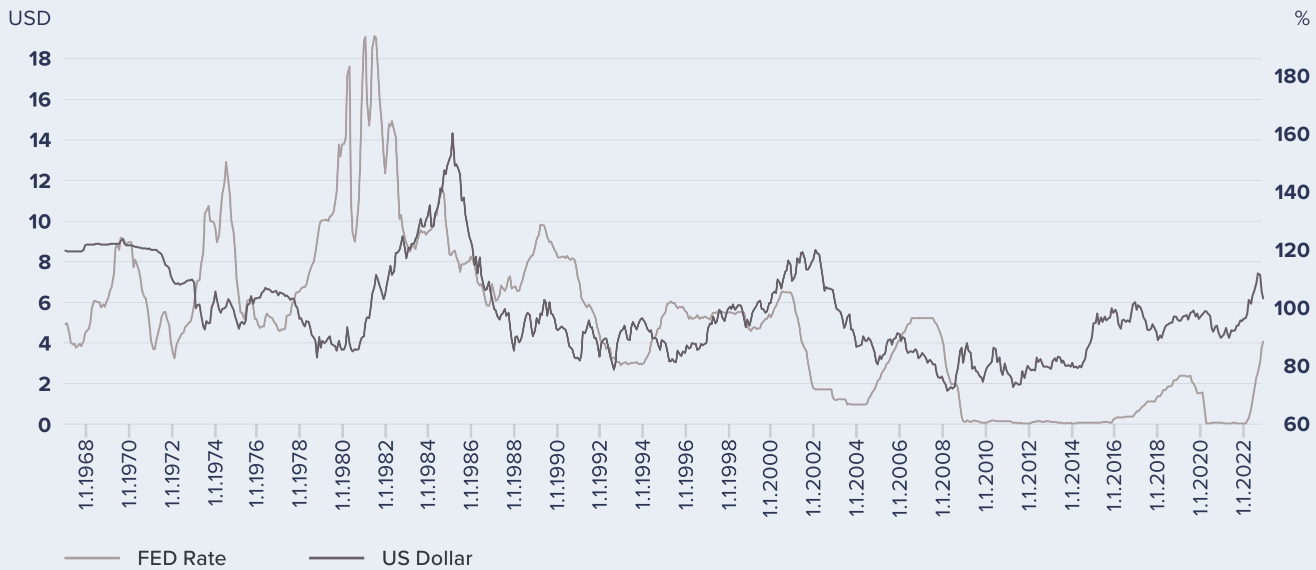
2022 has been a year of resets. While an important reset in price/earnings took place through earnings multiple contractions within equities, the reset was much bigger in rates and the fixed income universe.

While the FED by itself hiked by four and a quarter percentage points in 2022 alone, the cumulative hikes by central banks of the 10 most traded currencies added up for a record +2700bps in 2022 alone. Even though this transition into a higher rate environment and the end of cheap and even free money was painful, we believe that the core principles in investing into fixed income still hold with even greater potential in the upcoming years. While 2022 had a second lowest starting yield (10Y US treasury) in a sample of 237 years but the 30th highest starting YoY inflation level (and rising), 2023 has started more accommodating with only the 101st lowest starting yield and 35th highest ever YoY starting inflation (but falling). Going forward with the rate outlook, much of the move seems done and with FED funds currently indicating the target rate should be reached early summer of 2023. Even though there is currently still some contraction to where the market sees the first rate cuts vs to what the FED has communicated in its last dot plots in December 2022, the adjustments between the two visions should not create too much volatility and see a gradual convergence somewhere in the first quarter. The reinforcement of our fixed income pocket has been done rather gradually since the last couple of months, with the focus shifting from short-ended bonds to applying a more barbell strategy to add longer dated maturities as well.

We do expect the next several quarters to be characterized by subdued growth or mild recession without a spike of meaningful increase in default rates.

This also supports our view on adding more quality credit and increasing the overall duration in our fixed income pocket as this asset class typically behaves well during such economic cycles. Bonds have precious values such as consistent income, capital growth and lower historical volatility (exception 2022) which should be present in any multi-asset portfolio. Even though the current inversion does not offer an interesting term premium for investors ready to take more duration risk and also come in favour of rolling down the curve, including longer term bonds help mitigate the reinvestment risk should interest rate levels fall importantly at the time short-term bonds mature. With the getting closer to peak rates comes the tiredness of the USD. As observed in the graph, correlation of the USD strength vs the FED policy rate is clearly visible. It is also striking at which speed the USD depreciates once the FED starts hitting the breaks. The peak to troughs can be very painful as well on the USD once it reaches extreme overvaluation. Even though there could be further room for downside on the USD, the recent moves have already discounted quite aggressively the point of peak rates. We prefer to stay on the side-lines for the time being and not take any active risk on the US following the strong move.

FED Rate vs. USD



Date: 9th of February 2023 Source: Bloomberg

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