Letter from the CIO

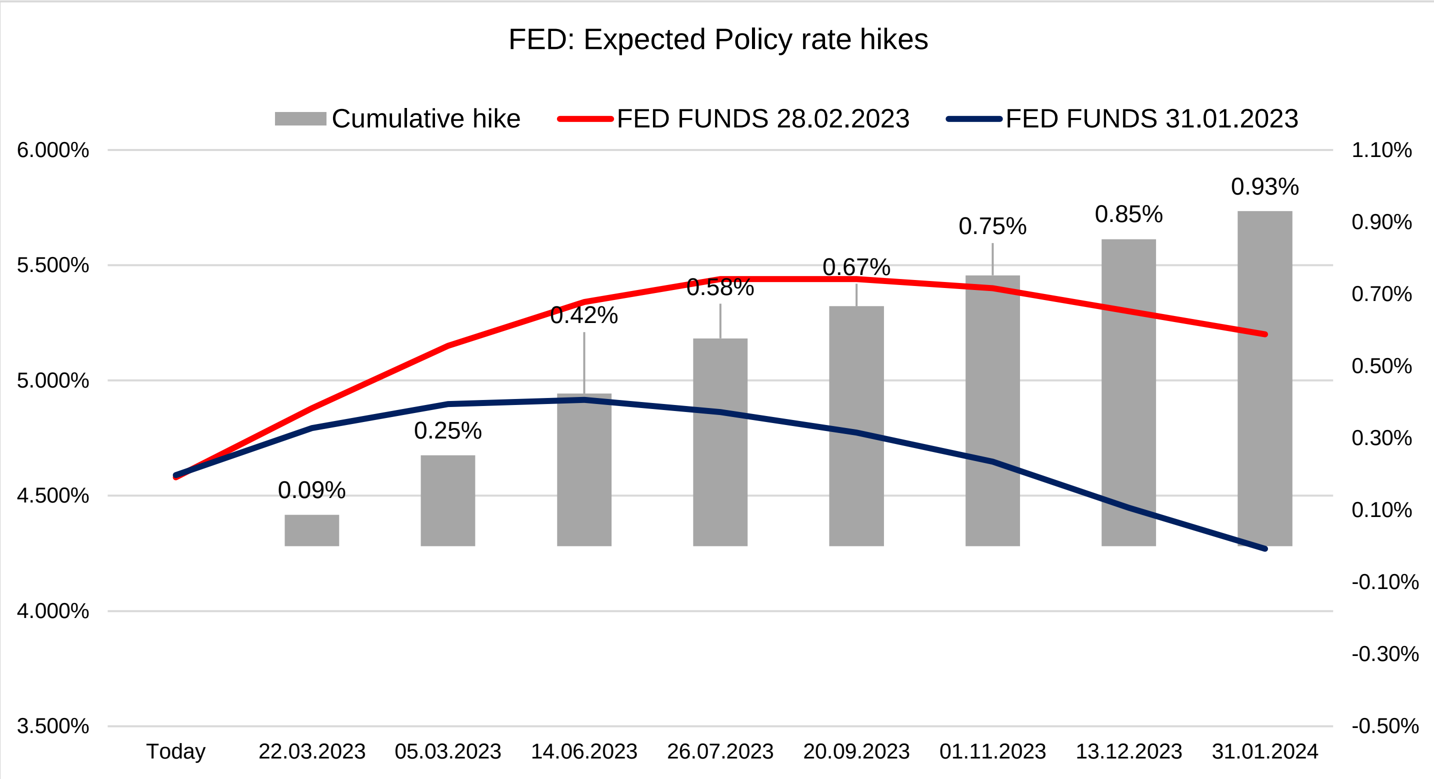
March 2023

A bit of disillusion

February has just ended and the euphoria of the first month of the year has unfortunately not been repeated! Even worse, February saw the return of positive correlations between equity and bond markets, an important phenomenon that was the main reason for the portfolios' disappointing performance last year. Whose fault was that? Inflation, of course! It was thought to be falling on both sides of the Atlantic, paving the way for the end of restrictive monetary policies and the sweet dream that recession might even be avoided! Unfortunately, January's inflation figures brought everyone back to reality. In both the US and Europe, the latest price data came in higher than December and well above consensus expectations. The result was a sharp rise in bond yields, a fall in equity markets - especially in the US - and a strengthening of the dollar. In the US, the S&P500 index ended the month down 2.1%, penalised by interest rate sensitive sectors (real estate, utilities) and the energy sector, with WTI down 2.4% over the month. Conversely, growth sectors tended to hold up better, closing down by 0.9%. In Europe, equity markets were more resilient to the sobering inflation figures. Value companies, particularly those in the energy and financial sectors, performed well. The Stoxx 600 index ended the month up 2.2%, while the German DAX closed the month up 1.7%. The Swiss SMI index was unable to stay in positive territory and closed the month down -2.4%. Credit Suisse (-9.4%), Alcon (-7%) and Roche (-5.7%) were the three biggest detractors over the period. Finally, the MSCI Emerging Markets Index posted its biggest February fall (-6.9%) in over 20 years, hit by geopolitical risks and fears that US interest rates will remain high for longer than expected. China's Hang Seng Index was down -8.6%, while the Brazilian market was down -6.8%. On the bond side, the curves almost immediately priced in the latest inflation figures, pushing yields higher. The US 10-year yield rose by 50 basis points to end the month just below 4%, while in Germany the 10-year rate ended the month at 2.65%, almost 40 basis points higher than at the end of January.

The Personal Consumption Expenditure (PCE) price index rose by +0.6% in the US in January, beating expectations of +0.4%. We have to go back to August last year to see such an increase. After +0.3% and +0.2% in December and November respectively, this renewed inflationary pressure, coupled with a still resilient US economy, has swept away any hope of the FED reaching its famous near-term turning point. Inflation remains too high for the Fed to ease the pressure, and the market has been quick to reflect this. It now expects three more rate hikes in 2023, taking the Fed funds rate to almost 5.5%. So no rate cut until 2024! Also in Europe, fears of a stronger-than-expected tightening of monetary policy have resurfaced in February, following the publication of inflation figures in France and Spain in recent days (+7.2% and +6.1% respectively). In the eurozone, while prices have been rising at a slower pace since October 2022, inflation reached +8.5% year-on-year in February, roughly the same level as in January. Importantly, food inflation outpaced energy inflation for the first time since mid-2021.

Inflation excluding food and energy also increased. It rose from +5.3% year-on-year in January to +5.6% in February. Price pressures therefore appear to be spreading more widely across the economy. The market is now expecting that the ECB will have to raise its key rate (currently at 2.5%) to 4% by the end of 2023 - early 2024 - a level not seen since the creation of the euro. As a reminder, the expected terminal rate just a few weeks ago was 3.5%!



Source: Bloomberg / Banque Heritage

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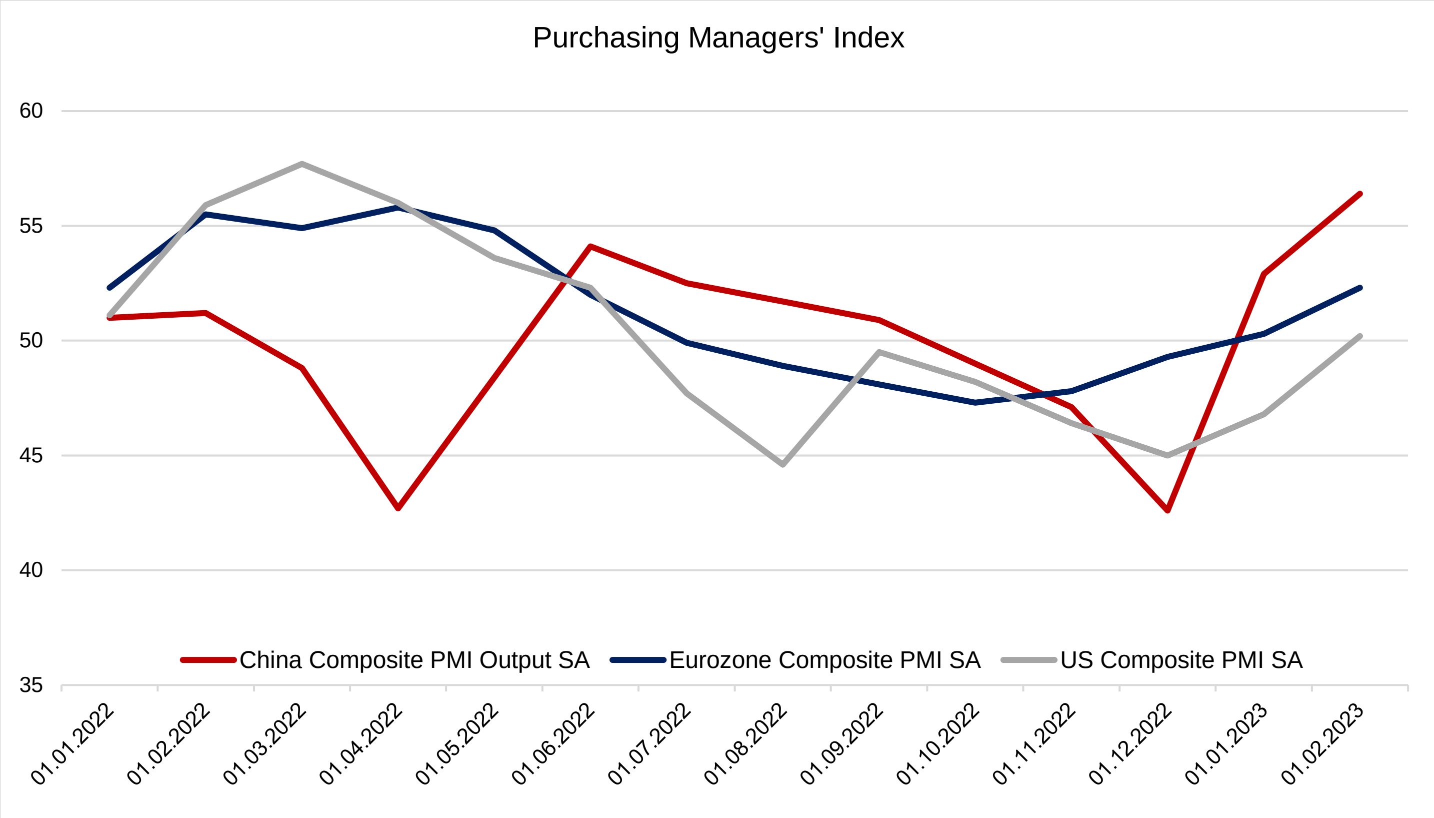

Source: Bloomberg / Banque Heritage

Nevertheless, we remain cautiously optimistic about the next 12 to 18 months. Inflation remains high and will probably take longer to return to the targets set by the FED and the ECB. Markets will remain volatile as long as central banks continue to tighten. At the same time, other factors remain promising in our view, confirming our balanced positioning. Chinese economic activity is growing at a steady pace following the government's announcement to reopen the economy. The purchasing managers' index (PMI) for the manufacturing sector reached 52.6 in February, the highest level since April 2012. In January, the reading was 50.1, up sharply from the previous month. China will certainly be an important player in the global economy in 2023

The Bloomberg Global Aggregate Bond Index returned +3.3% in January, its best month of January since inception in 1990, but then lost almost 3.3% in February, its worst February ever! Stronger-than-expected US economic data and more persistent inflation led investors to raise their forecasts for the FED's terminal rate. However, despite this volatility, we remain convinced that current conditions are much better than they were in the third quarter. Lower energy costs, a mild winter, economic resilience or a strong rebound in China... all variables that lead us to believe that current yield levels are reaching their equilibrium point!

To be continued!

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