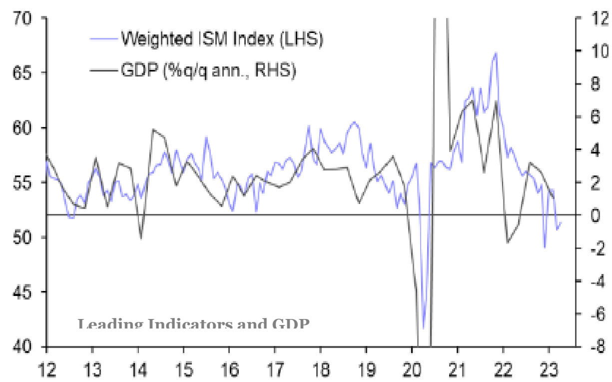
MARKET OUTLOOK

2023/June

ECONOMY: A POTPOURRI

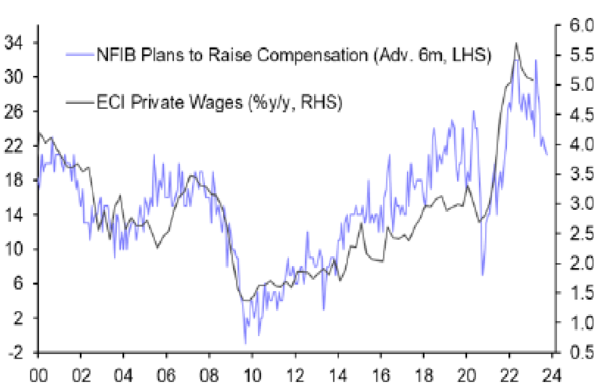
"There are only patterns, patterns on top of patterns, patterns that affect other patters. Patterns hidden by patterns. Patterns within patterns. If you watch closely, history does nothing but repeat itself" – Charles Michael (Chuck) Palahniuk, novelist.

Roughly two months after our last update, the macroeconomic picture has not changed meaningfully. The trends that we observed in April have persisted; while coincident indicators remain strong, leading economic indicators continue to contract. The big news of the quarter is that economic weakness has begun to emerge also out of the services sectors. While we had become acquainted with the manufacturing branch of the economy being in, or close to a recession, the fact that services are starting to feel the pain is a change, but not a surprise. Despite an economy less sensitive to changes in the level of interest rates, a rise of 500 basis points in slightly more than a year will have (profound?) effects on the overall state of the economy, starting from the demand for goods and services. Real GDP growth has remained resilient for a few quarters, hovering around the 2% figure. But as higher rates begin to feed through the economy, we continue to believe a recession is inevitable, especially in the presence of persistently high (core) inflation, which forces the US central bank to keep a hawkish stance.

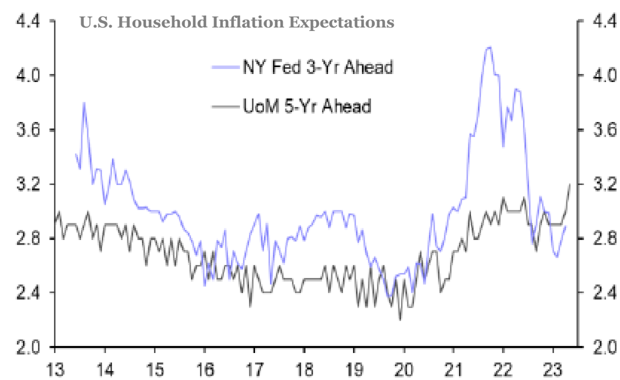


As a reminder, consumption is the main driver of US economic growth. Over the past year, while other parts of the economy were slowly surrendering under the pressure of rising interest rates, the American consumers, aided by excess savings and pandemic-related fiscal stimuli, continued to support the economy by spending a bigger chunk of their incomes compared to the long-term average. However, we are now at an inflection point; the propensity to save is mean reverting, as relief programs are coming to an end and household reserves are drying up. Proof is that retail sales growth, while still positive, is approaching the zero line. The last bastion is shaking.

The other meaningful change witnessed over the quarter is the beginning of a *U-turn* in the job market. With both goods consumption and services slowing, it is only natural for the labour market to come off its extremes. While job offers remain in excess of job demands, this ratio is falling. Simultaneously, continuing jobless claims have risen more than 30% from their lows, a sign that in the past has often been associated with a looming recession. Moreover, companies' plans to raise compensations are decelerating, capping wage growth at around 5%. As high interest rates have just started to feed through to the economy, we believe the worsening in the labour market (albeit from extreme strength) is at its dawn.

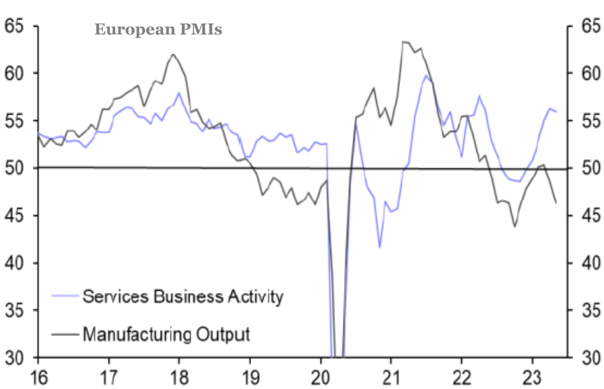


With consumption slowing and the labour market weakening, inflation should resume its downward trend. Admittedly, the stickiness of inflation has caught many investors by surprise; the latter have been pricing in a more dovish stance by the central bank for some time, but the recent data relative to the price of goods and services has highlighted the need to stay alert, as confirmed by the very same Federal Reserve. In fact, extensive research has shown that the main driver of inflation is...inflation itself, stressing the psychological factor underpinning this economic phenomenon. In this respect, the recent bounce in household long-term inflation expectations does not bode well for the more optimistic out there.



Overall, the American economy remains a mixed bag, with the housing market mirroring it well. Mortgage applications are close to record lows, but years of underinvestment is supporting house prices. Higher mortgage rates are making new homebuyers shy away from their first purchase, but are not impacting current homeowners, whose mortgage rate is fixed and very long-term. Thus, while the current economic slowdown should continue, it will take place gradually. History shows that elevated interest rates for a prolonged period eventually cause a recession. The deep inversion of the yield curve *agrees* with it. We don't see why this time around things should be any different. *History does nothing but repeat itself.*

The European economic cycle is catching up to its U.S. peer; the manufacturing sector has been in a recession for some time, which is the reason why Germany has officially fallen in a technical recession after two consecutive negative GDP prints. But it does not feel like we are in a recession, especially when speaking to the management of several European firms; according to them, the outlook is brighter than what current and forward-looking data assume. Surely, the services sector is holding up well, driven particularly by the Southern European countries. But here too there are signs the services business activity is normalizing. Thus, with a very restrictive central bank and persistently high core inflation, we continue to believe a slowdown in consumption is around the corner. A very similar situation to Switzerland, where a global economic slowdown, the recent consolidation of the financial industry and a hawkish central bank despite relatively low inflation, are all expected to keep the economy under pressure for some time.

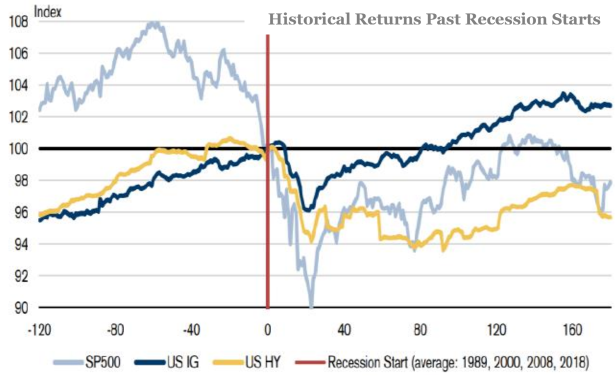


Our concluding remarks are reserved for China; after a tepid rebound following the economic re-opening, the economy is now in extreme need for more monetary stimuli. The real estate market, which represents a big chunk of the domestic economic growth, and of household savings and investments, remains under pressure. Acknowledging the problem, the central bank lowered the main refinancing rate to revive credit growth but, looking at the bigger picture, the challenges for the economy persist as the world flirts with a global recession. Thus, Chinese authorities are likely to be called into action, again.

FIXED INCOME: SYNCHRONIZING EXPECTATIONS

Bond investors have finally aligned their expectations to the wording of central banks. Interest rate curves in general don't price any cuts for the current calendar year, but only see rates falling towards the beginning of 2024, more in sync with the expectations of monetary authorities. The yield curve of many major economies remains heavily inverted, signalling an increasing risk of a recession taking place over the next 6-18 months, which is also our base case. With that in mind, current short-term government bonds look attractive. The same is true for high investment-grade bonds, as fundamentals are very strong – low leverage ratios and high EBITDA margins – and valuations below the long-term average. Moreover, during the months following the beginning of a recession, investment grade bonds historically have shown to outperform riskier assets such as higher yielding bonds or equities.

The same cannot be said for higher yielding bonds. High yield default rates are on the rise since the beginning of 2022, and fundamentals are set to worsen further as credit conditions tighten. Moreover, valuations are not attractive, as the credit spread compared to safer fixed income investments is below the long-term average. This is particularly mind-boggling when considering the current economic environment.



In terms of duration, that is whether to purchase short-term bonds or selecting maturities further out on the yield curve, we tend to favour the former despite our base case scenario is for rates to fall as the recession nears (as a reminder: if rates fall, the higher duration the investor owns, the higher the price appreciation the investor will enjoy, and vice-versa). The reason is two-fold; firstly, with an inverted yield curve, the term-premium is currently zero (or close to it) – bluntly put, investors are not paid to take on duration risk. Secondly, investors seem too complacent about the future path of inflation and are assigning little or no possibility for the latter to pick-up again. Yet, as mentioned earlier, the best predictor of inflation is inflation itself, which means interest rates could have further room to run, long-term maturities included.

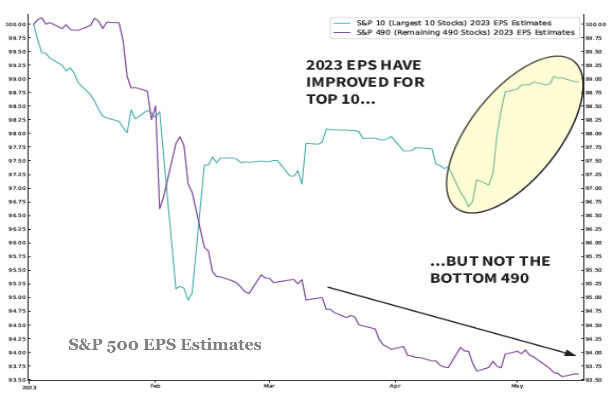
History shows that elevated interest rates for a prolonged period eventually cause a recession. (...) We don't see why this time around things should be any different.

EQUITY: STICKING TO REALITY

"*As long as the music is still playing, you've got to get up and dance.*" – Chuck Prince, Citigroup CEO, Year 2007.

No, we don't think we are in front of a 2008-style equity crash. But this quote is important because it reminds us all that the music can suddenly stop playing, and sometimes not even the members of the orchestra know when the music has come to an end.

As both professionals and investors, we are data dependent. Clearly, we too try to make forecasts on earnings growth, margins, costs, etc. and base our investment decisions on them, but these forecasts need to be reasonable. Today, we believe equity investors are being too exuberant about future expected returns. The performance of the S&P 500 to date is driven by the ten largest stocks, which in turn are riding the wave of excitement brought upon by the advent of artificial intelligence. Here lies the first piece of exuberance; artificial intelligence has been among us for the past 5-7 years, why all the fuss now? No doubt artificial intelligence will be a major driver of earnings growth going forward, especially if it can be used to prop up American productivity, currently dismal. But it will not happen overnight.



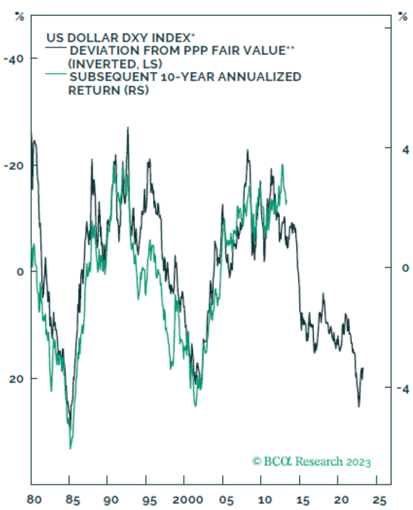
Secondly, the price returns of the remaining 490 companies are close to zero; historically, this is not a sign of a healthy equity rebound. Research shows that, on average, the equity returns during the months following a performance divergence between mega-cap stocks and the rest of the market have been negative. Thirdly, earnings forecasts have been rebounding, and according to what we have mentioned during our last Market Outlook, this is the proof that the lows of last October were *the lows*, and what lies ahead is a path characterized by flourishing earnings and investors' satisfactions. However, if we exclude the rebound in earnings forecasts for the ten largest stocks, you will be confronted with a very different picture, portraying a continuation of the negative trend that started at the dawn of the year. With an economy heading for a slowdown, what are the chances that earnings will suddenly rebound?

Finally, even if you omit all that has been written so far, what should make you hesitant of investing into equities at this juncture is their current valuation, which is expensive, and is expensive across the board, not just for the mega-caps mentioned earlier. Thus, while we know that markets don’t correct because of expensive valuations – they need a trigger event, which is often unexpected – we continue to believe investors should be very cautious regarding their equity investments. Future returns are (also) based on the price you pay for the cash flows you will receive; if the price paid is too elevated, your future returns will be low. It is as simple as that.

The story is totally different overseas. While earnings are set to contract in line with an economic slowdown, European equity markets are cheap, and have been getting cheaper for a while. Moreover, what is interesting is that its attractiveness is broad-based, as the number of companies whose price/earning ratio is below 10x has been rising for a while. Thus, on a relative basis, we see less downside risk by investing in the European markets (including Swiss equities) compared to U.S. stocks.

In terms of sectors, given our prudent view on both the economy and the forward path of earnings, and based on current valuations, we favour industrials, consumer staples, and health care names.

COMMODITIES AND CURRENCIES: USD BULLISH, FOR NOW



More cyclical commodities have suffered price declines since the beginning of the year; the uncertainty regarding the economic outlook and subdued growth from China are the main reasons behind the poor performance. We believe this trend will continue until the outlook for the global economy is clearer. On the other hand, precious metals have fared better, as real interest rates have remained compressed. But rising volatility in financial markets could be beneficial for the USD, which in turn is negatively correlated with most of the commodity space.

Speaking of the greenback, there are a few factors that make us constructive over the short-term; on the one hand, history shows that the USD continues to appreciate even after the last rate hike. Strengthening the thesis, according to the last Federal Reserve minutes, there will be more hikes down the road. On the other hand, the American currency has often appreciated during financial stress, for example at the onset of a recession. However, longer-term our view is drastically different; we believe that the USD is on a structural negative trend hence any periods of strength we regard as opportunities to reduce its exposure. The EUR and the CHF should be the main beneficiaries, along with the Chinese Renminbi.

OUR STANCE

Liquidity: Underweight ▼	**Bonds**: Equal Weight =	**Equities**: Underweight ▼	**Alternatives**: Overweight ▲	**Commodities**: Overweight ▲

CONTACT US:

Massimo Borghesi, CIO

LFA – Lugano Financial Advisors SA

Via F. Pelli 3

6900 Lugano, Switzerland

O. +41 91 922 69 18

borghesi@lfa.ch

www.lfa.ch

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