SWISS Wealth Management for US Clients

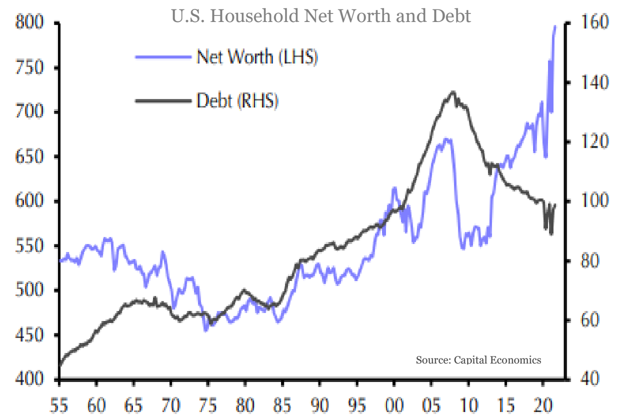
MARKET OUTLOOK

2022/February

WAGE INFLATION THE MAIN RISK TO LOOK OUT FOR

Contrary to many, we don't think the economy resets with the start of the new year therefore, we would like to begin where we left of at the end of October and try to create a fil rouge across time.

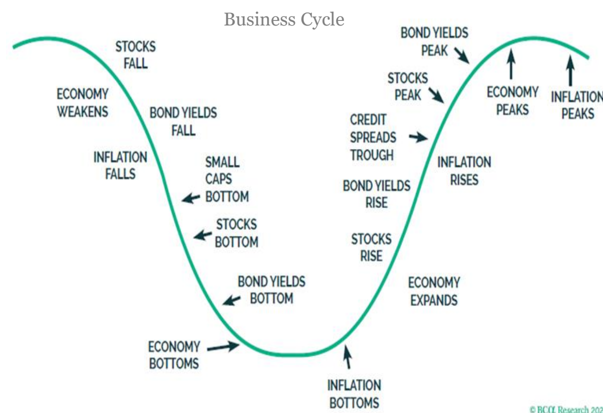
We had mentioned that a few regions around the globe were close to reach heard immunity and that the situation around the pandemic was under control. While herd immunity remained an illusion as the highly contagious Omicron variant spread forcefully, the healthcare systems did not collapse because of high vaccination rates and the latest variant being less virulent. This allowed governments to keep their economies open, despite a few restrictions on mobility, supporting the economic rebound that took place throughout 2021.



Therefore, after the quickest recession on record, the world economy is continuing its renaissance from the underworld. The preconditions experienced throughout 2021, necessary for economic growth to continue, are still with us, despite a few of them having lost part of their impetus. For example, disposable income is still elevated, but has fallen from its peak, and even more so if we look at real disposable income, that is considering the effects of inflation. Households' financial health is stable and has never been this healthy in more than twenty years while net worth, supported by surprisingly strong financial market returns, has skyrocketed.

Governments will continue to support their respective economies by implementing fiscal policies that, on aggregate, will not shrink the budget deficits, thus avoiding imposing austerity measures anytime soon, despite the financial aid unleashed over the past couple of years has expired.

The latest hawkish twist in stance by the Federal Reserve (FED) has unnerved some market commentators, who categorized the move as too aggressive, and financial markets indicators initially pointed to renewed risks of an upcoming recession. However, the reality tells a different story; financial conditions are currently very loose and would remain as such even in the case the consensus was correct when forecasting four to five hikes for the current calendar year. Thus, all being told, the environment remains benign and supportive of economic growth, although the latter is expected to slow over the coming quarters, as foreseeable in this phase of the business cycle.



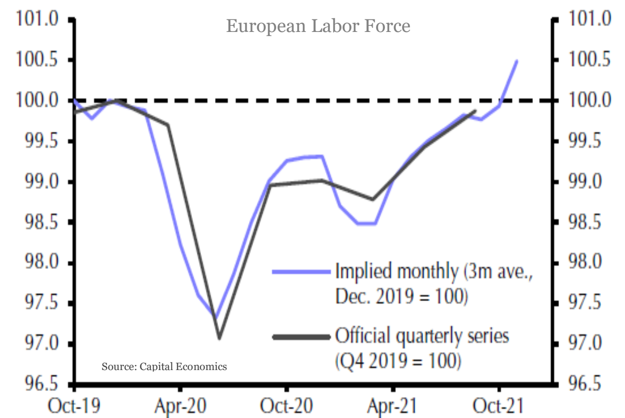
The main risk is that inflation, contrary to economic growth, continues to rise, which would prompt the FED to accelerate the tightening of its monetary policies, with negative spill-over effects on GDP growth.

While debatable, we would argue that energy prices should come off their peaks, or at least slow markedly their upward run, as supply shortages should ease and prospects of decelerating economic growth may weigh on demand. Moreover, at these prices, there is an economic incentive by suppliers, such as OPEC and US shale producers, to increase production, and we would not exclude rising political pressures to cap prices, as it happened few years ago under the Trump's administration. On the

other hand, the US labor market is experiencing severe shortages, feeding into upward wage pressures. The labor force has not recovered its pre-pandemic levels, although the latest, revised data suggests we are not far from it. This is good news because it could slow wage inflation down, which is considered to be the spark of the much-feared inflation spiral that often leads to prolonged periods of sustained overall price pressures.

To sum it up, rising prices and FED tightening will slow economic growth down, but the latter may settle at pre-pandemic levels, if not a tad higher, supported by an environment characterized by a general propensity to spend and loose financial conditions.

LESS OVERHEATING OVERSEAS

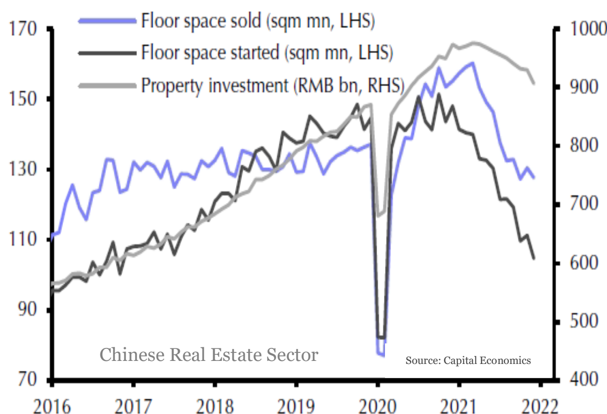


If we look outside of the US, different regions are at different stages of their business cycles. In Europe, except for Germany, where the automotive sector is still suffering from supply shortages (but the latest data point to improvements), and Spain, who suffered from traveling restrictions due to the pandemic, GDP is now close to pre-pandemic levels, while the labor force is expected to soon rise above it.

A cooler labor market, and a consumer base that is by nature more conservative and has received fewer financial assistance during the pandemic, has led to a more moderate rise in inflation. The latest figure is still above the average of the past 10 years, but much is related to energy shortages, which we believe will fade over the course of the year (our base case excludes an outright war between Russia and western allies). On the other hand, core inflation is closer to the European Central Bank's (ECB) target rate of 2%, but given recent survey results, in the near term it may be possible it will not fall further.

The latest rate cuts by the Chinese central bank highlight how the pandemic has disrupted what once was a world experiencing a highly synchronized economic growth.

Europe's economic prospects are encouraging; consumer confidence remains stable and above pre-pandemic levels, monetary conditions are still extremely loose because the ECB will not hike interest rates for at least another year, and tourism-oriented regions such as the southern countries should benefit from what it seems could be the start of the end of the pandemic. That said, given the influence that exports have on the overall economic growth of the region, we think that China's controlled slowdown will weigh on what is otherwise a bright outlook.



Speaking of which, the latest rate cuts by the Chinese central bank highlight how the pandemic has disrupted what once was a world experiencing a highly synchronized economic growth. China ended 2021 with numbers exceeding expectations, but the crackdown on the real estate market is not over and will continue to weigh on economic growth, alongside its zero-covid strategy.

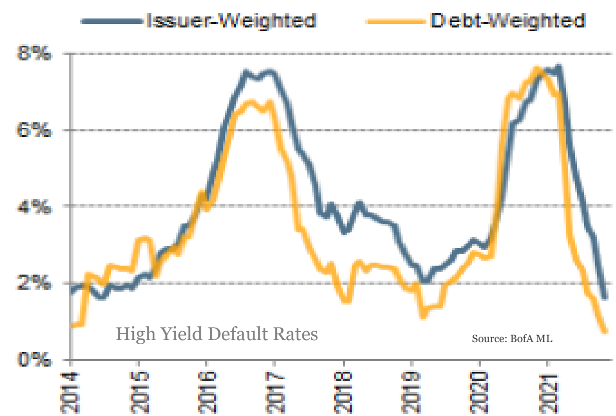
The pandemic has had a controversial effect on China's output. As mentioned, its zero-covid strategy is having downward pressure on internal consumption, especially on the services sector; simultaneously however, external demand for Chinese products has increased over the past couple of years, sending export growth soaring. Due to strong demand, capacity utilization has

remained above average, prompting elevated investments within the manufacturing sectors. We doubt this trend will continue going forward, as exports should fall with the pandemic fading, calling for further stimulus by monetary authorities.

Because of a slowing population growth, it is undeniable that Chinese growth will be lower during the next ten years compared to the previous ten. However, Chinese monetary authorities, contrary to their global peers, still have plenty of ammunitions to support economic growth and ensure that a soft landing is achieved. And, as opposed to other major economies, both the labor market and inflation don't show any signs of overheating. Therefore, all being told, and bearing in mind the risks related to interventionist policies by the Communist Party, the Chinese economy shows signs of stabilizing.

FIXED INCOME: IN THE MIDST OF THE TURMOIL

Hardly over the last decade have we witnessed a more hostile environment for fixed income investors. During the 4th quarter of 2021, the FED has delivered a big hawkish shift by acknowledging inflation is more a permanent than a transitory factor, prompting market participants to adjust their expectations accordingly. The committee also shortened the length of its tapering process, which is now expected to end in March of this year, ahead of forecasts. Furthermore, the central bank dots plot (the summary of the committee members' rate projections) now encompasses three full hikes in 2022, but markets are discounting a more hawkish scenario. Lastly, and according to Chairman Powell, during the meeting in January the committee members began to discuss the appropriate timing for reducing the FED balance sheet. Rumors on the street point to the second half of the year.



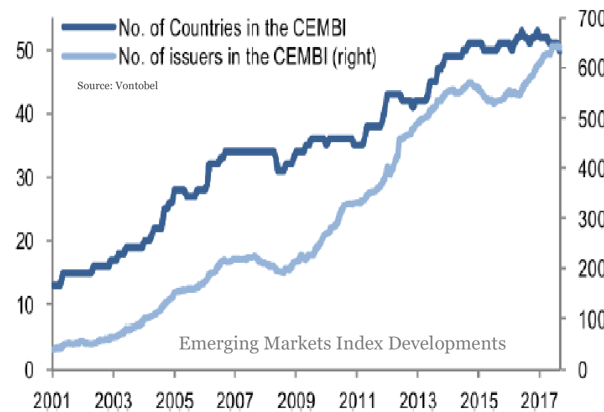
While other central banks are already engaged in hiking rates (see the Bank of England), currently the big dichotomy among developed economies is to be found in the policy of the ECB. Notwithstanding the latter is effectively reducing the level of economic support by slowing the pace of bond purchases, no official rate hikes are yet envisaged until end of 2024. This forecast, however, has been put in serious question at last week's monthly meeting, given the recent spike in the December inflation reading. Consensus believes the ECB will be forced to start raising rates at the end of this year – beginning of 2023, and is pricing fixed instruments accordingly.

Fixed income government yields have reacted in line to the FED turnaround. The US curve flattened markedly during the last part of 2021, as the 2-year rate moved substantially higher. In January, the 10-year rate followed, rising towards the current level of 1.90%, also benefitting from reduced fears about the economic impact of Omicron. In Europe, long term rates rose too, as high inflationary readings supported the view that the ECB may have to act sooner than expected.

On both sides of the Atlantic, corporate investment grade spreads widened, with yields suffering as long duration exposures took a bite. Valuations are still stretched even if spreads recently converged somewhat towards the historical average, hence it is no surprise that absolute yields, despite the recent upswing, remain unattractive, especially if considered that fundamental parameters are slightly deteriorating too.

High yield U.S. defaults and credit metrics, such as leverage, keep on pointing into the right direction and recent performance was better than the investment grade counterparts. Valuations are stretched on an absolute basis but still offer

value in relative terms, especially when taking into consideration (callable) short term bonds and rising stars candidates (companies whose credit rating may become investment grade).



The fundamentals of emerging corporate debt continue to improve both in terms of credit metrics and valuations. The historical risk/reward profile is compelling too when compared to other fixed income buckets. The asset class is also fast growing in terms of size, diversification, and liquidity. However, if history is any guide, the US rates hiking cycle clearly represents a risk for the emerging market space, given the high level of USD-denominated debt emerging markets are exposed to.

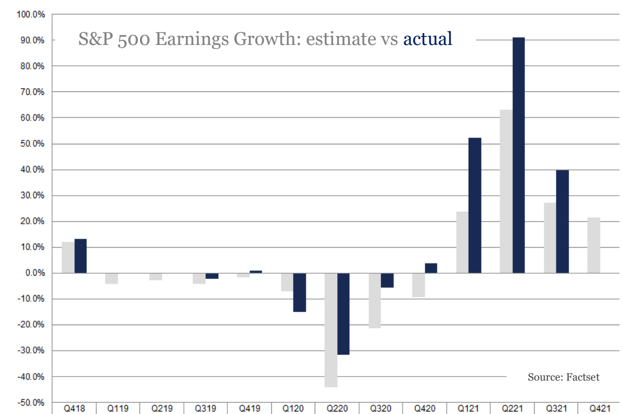
Overall, the asset class looks expensive in terms of absolute valuations, and yields offered are not compelling either. Positive economic growth forecasts and a more hawkish stance by most global central banks are among the reasons why duration exposure remains a risk. In relative terms, pockets of value are still left in some niches of the riskier buckets of the fixed income space, such as short-term high yield, emerging corporate debt, and senior loans.

EQUITIES: WITH CAUTION, STILL THE PLACE TO BE

A contested presidential election, an assault on the Capitol, supply chain disruptions which led to the highest inflation rates since decades, and around 4.5 million of American workers that have left the labor force, were not enough to stop equity prices from rising throughout 2021. Indeed, against a backdrop of high vaccination rates, easing lockdown measures and a broad-based economic reopening, the S&P 500 rose by about 27%.

However, the new year started off on the wrong foot; with financial aids fading, the FED hinting towards tighter financial conditions, and the geopolitical tensions between Russia and the West which are keeping energy prices in check, the major equity indexes have sunk.

Nonetheless, American companies are set to lengthen their extraordinarily positive winning streak of earnings reports. For Q4 2021, the S&P 500 is expected to report earnings growth of 20.7% year-on-year (YoY). This figure may even be too conservative if we look at the average earnings surprise of the past five years; accounting for the latter, it is likely the index will report earnings growth of nearly 30% for Q4, which would be the fourth consecutive quarter of earnings growth at or above 25%. Astonishing.



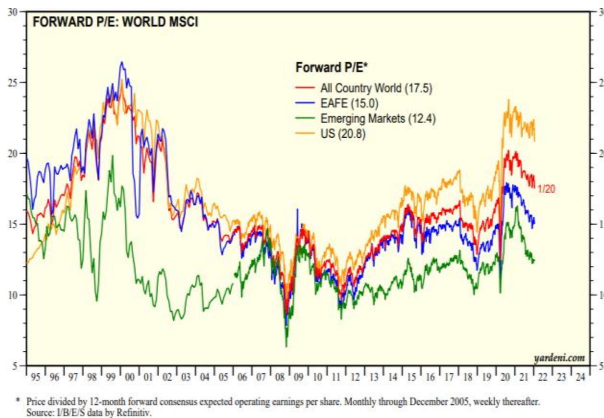
But all good things come to an end, and in line with decelerating economic growth, 2022 and 2023 YoY earnings growth should also subside, likely towards 10%. Similar growth is expected from Swiss companies, where the anticipation of rising bond yields should benefit the financial sector, preponderant within the SMI index.

Remaining in Europe, analysts expect profit for STOXX 600 companies to grow 48.6% in the fourth quarter, with energy, basic materials, industrial and the financial sector likely to see the biggest growth.

US equity valuations calculated via the cyclically adjusted P/E ratio remain rich compared to the rest of the world, but are improving since September 2020, thanks to very strong earnings and the recent market correction. The 1-year forward P/E

ratio of the S&P 500 is now close to 20. In Europe, despite rising share prices during the last quarter of the year, higher earnings made valuations cheaper (MSCI Europe 1-year forward P/E dropped from 15.4 in Q3 to 14.5 in Q4).

Emerging market valuations remain attractive; tighter monetary policies, a stronger USD, and China's slowdown have contributed to keep prices subdued compared to western indexes. A poor management of the pandemic did not help too. However, as mentioned earlier, the easing of mobility curbs as the pandemic fades, the monetary and fiscal support by Chinese authorities, and a shift in communication by the government (the emphasis on the word "stability" by Chinese policymakers on several of their speeches) should help Chinese equities bounce back, dragging along the whole of Asia.



In the current phase of the business cycle, where both economic growth and inflation (should) have peaked, it is advisable to take a conservative stance in terms of sector allocation, at least according to historical returns analyzed in the literature. In this environment, some sectors usually outperform others; consumer staples and healthcare tend to perform better because they offer stable and certain, albeit relatively low, earnings growth, in an environment that is becoming more uncertain due to the FED policy changes and economic slowdown. Energy and financials have also shown their effectiveness in protecting against inflation, and may be a good addition to the portfolio if the former is set to remain elevated for some time.

Despite persistent risks such as the geopolitical situation surrounding Ukraine, the pandemic, supply chain bottlenecks, and fears about inflation and interest rates, the outlook for the equity market remains moderately positive. That is partly because some of these risks we perceive to be more temporary, and partly because the relative valuation of equities compared to bonds remains attractive, at least according to the risk premium expressed by the Shiller's Excess Cape Yield (ECY), which represents the difference between the earnings yield of stocks and the yield of the 10-year inflation-adjusted US Treasury.

Recovery 1 Year	Expansion 3 Years	Slowdown 1.5 Years	Recession 1 Year
• Economy Rebounds • Consumer expectations improve • Discretionary spending increases • Accommodative monetary policy	• Growth reaches its peak • Increase in CAPEX • Interest rate starts rising • Strong credit	• Positive but decelerating growth • Monetary policy tightens • Positive output gaps	• Economic output points to the bottom • Falling demand • Softening monetary policy
+ **Consumer Discretionary** **Real Estate** **Materials**	+ **Financials** **Technology**	+ **Consumer Staples** **Health Care**	+ **Consumer Staples** **Utilities** **Health Care**
− **Consumer staples** **Utilities**	− **Health care** **Utilities**	− **Consumer Discretionary** **Real Estate**	− **Real Estate** **Technology**
➢ GDP from negative to positive ➢ Sales increase ➢ Household income increases ➢ Low Interest rate	➢ Earnings' positive momentum ➢ Businesses have a lot of cash ➢ Economic indicators decelerate ➢ High spending from Businesses and Households	➢ GDP growth start moving from positive to negative ➢ Rising inflation ➢ Interest rate soars ➢ Unemployment increases	➢ Businesses' profits decline ➢ Interest rate drops ➢ High unemployment ➢ Household income decreases

Phases of the Business Cycle

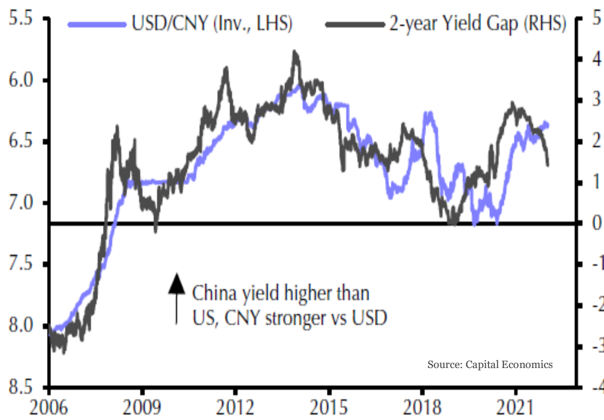
Source: State Street

In terms of regional allocation, in the U.S. the FED normalizing rates and high absolute valuations may pose a threat to the best performer of the last decade. But the promising start of the earnings season (including big tech companies like Apple and Microsoft, which carry a substantial weight in the index) offers the region the benefit of the doubt; stay neutral. On the other side of the Atlantic, European valuations remain attractive, and the underweight in technology has helped the indexes outperform the US market. Given the economic conjuncture, this time the outperformance may last for more than a few months; increase to slight overweight. Swiss stocks remain a solid and defensive addition to the portfolio, also supported by the safe-haven role of the domestic currency. If you are looking to sleep tight, this is the place to be. Finally, emerging markets are a big underweight due to their highly fragmented status, as the countries that compose the index have decoupled long time ago; thus, we recommend being selective, and focus on China's recovery.

COMMODITIES AND CURRENCIES: WINDS OF CHANGE

The recent appreciation of the USD is the result of a more hawkish stance by the FED, with markets pricing in four to five rate hikes for 2022. The outcome of tighter monetary policies is a widening interest rate differential, which has supported the USD until today. Going forward, we see rising downside risks for the greenback, emerging on the back of higher

inflationary pressures compared to other regions, such as Europe. Overseas, the recent EUR weakness can be attributed to a worsening current account balance (higher expenditures compared to income), because of higher manufacturing input prices deriving from a relatively more open economy. However, given supply bottlenecks are set to ease as the pandemic recedes, we are inclined to believe the worst is over for the European currency.



The recent appreciation of the Swiss Franc did not take away the sleep of the Swiss National Bank (SNB). Contrary to Europe or the US, inflation in Switzerland remained under control, and the strength of the domestic currency was one of the main explanations. The CHF remains a safe-haven currency, but looking at fundamentals, it is expected to depreciate over the longer-term, at least versus the EUR.

In emerging markets, the Chinese Renminbi is set to weaken; after a very positive performance in 2021, driven by a robust economic recovery, a combination of loosening monetary policies aimed at supporting a slowing economy, and a narrowing of the interest rate differential with major developed economies, will reduce its appeal, with the blessing of the Chinese government.

One final word, on gold; if our base case scenario is correct, real interest rates are bound to rise and, given the negative correlation between the two, the yellow metal is set to suffer because the opportunity cost of holding it increases.

OUR STANCE

Liquidity: Overweight ▲	**Bonds**: Underweight ▼	**Equities**: Underweight ▼	**Alternatives**:Underweight ▼	**Commodities**: Neutral ◀

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CONTACT US:

Massimo Borghesi, CIO
LFA - Lugano Financial Advisor SA
Via F. Pelli 3
6900 Lugano, Switzerland
O. +41 91 921 38 53
bosia@lfa.ch
www.lfa.ch

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