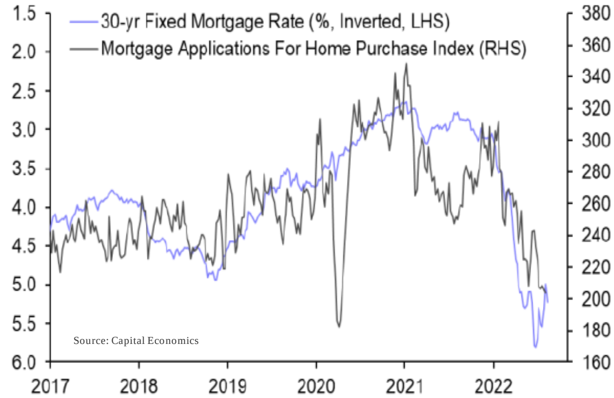
MARKET OUTLOOK

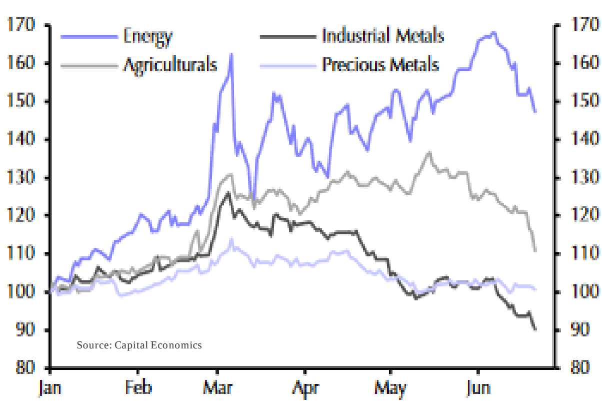
2022/September

ECONOMY: THE LAST MAN STANDING (AND FIGHTING)



US growth is again the last resort of the global economy; with China battling internal deficiencies, and Europe on the brink of a recession, much of the world growth is dependent on the US economy. The forecast for the third quarter GDP growth is reassuring (above 2% annualized) but the details reveal that the major contributor is related to one-off elements (exports of gold, which replace the market share once belonging to Russian gold exporters); this means it is highly probable the economy is already decelerating. In this environment, the very aggressive monetary stance the Federal Reserve (FED) is adopting to combat inflation isn't helping, to say the least; consumption of goods has already stalled, business investments are set to decelerate, and the steep rise in mortgage rates is curbing house prices. Hence, a question comes to mind: could it be that the FED is late, again?

It is true that inflation is nowhere near the two percent target, nor has it shown the willingness to move toward said figure; August inflation (excluding energy) was still rising, and surprised yet again towards the upside. Yet, it is not unthinkable to see inflation falling considerably over the next few quarters; used car prices have fallen hard, lower energy prices will soon feed into production processes, the prices of commodities (from industrial metals to agriculture) have surrendered the gains for the year as the global economic slowdown bites, and it is only a matter of time before lower prices in the real estate market have direct effects on both the services industry as well as the inflation basket. Proof of this can be found in forward-looking inflation expectations, which are back below three percent. And, while wage growth is still elevated, we are seeing a stabilization in the job market, with big companies announcing layoffs due to uncertainties regarding the economic outlook. Thus, it could be that FED members are talking tough to cap inflation expectations, but a pivot in the monetary policy towards a more dovish stance may not be too far out.



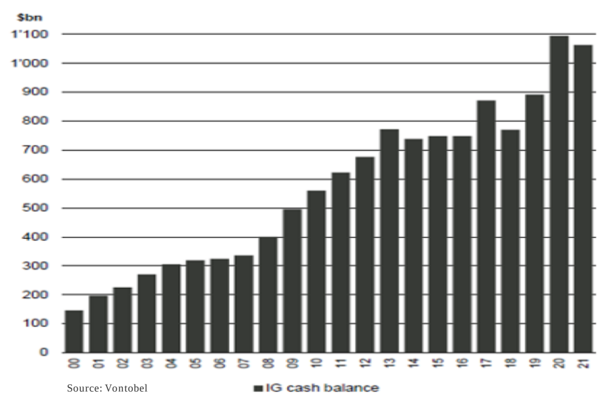
In the current environment, the probability of a recession happening over the next twelve months has increased. However, there are reasons to be less fearful of the future; the average consumer is in good shape, as debt levels remained in check despite the zero interest rate policies (ZIRP), and notwithstanding the awful performance of financial markets, overall net worth is elevated. The balance sheets of businesses are also healthy, as the latter hold conservative levels of liquidity and have taken advantage of the ZIRP to rollover and extend the maturities of their liabilities. Therefore, even in the case of a recession materializing, we expect it to be mild in nature.

While Americans face a cloudy sky, the Europeans and the Chinese are in the midst of a hurricane. Europe is in a semi-stagflation scenario ("semi" because unemployment is at all-times lows, and a stagflation scenario necessitates high levels of unemployment to be called that way); economic growth is flat and inflation is set to reach double-digits, considering the energy crisis is ripe to intensify with the upcoming winter season. The manufacturing sector has been in a recession for some time, while the services sector has fared better given its reliance on tourism. But the plunge in consumer confidence is an omen for future consumption, as high prices are already denting the ability of households to consume, at a time when the European Central Bank (ECB) has just started its rate hiking cycle to tame inflation. Thus, a recession will take place soon (if it did not start already), but it should not be a long-lasting one because, similarly to the US, the average consumer is healthy and little indebted, the Continent will decouple from Russian energy by the end of 2023, and as the winter season fades, the use of gas will diminish, supporting the consumption of alternative goods.

China is by no means in a stronger position than Europe. The deleveraging within the real estate sector and the zero covid strategy pursued by the central government are acting as a double whammy on the Chinese economy. The good news is that inflation is not an issue, as it is hovering around one percent. This allows both monetary and fiscal authorities to stimulate the economy, although big interventions are a matter of the past, with the former looking to avoid a further depreciation of the Chinese Renminbi and the risk of both capital flights and higher imported inflation. While in terms of potential output China remains top of the league, we believe it will take some time (and higher vaccination rates) before it can reinstate itself as the engine of global economic growth.

FIXED INCOME: ROCKY TIMES

Since our last update, interest rates globally have continued to rise as central banks worldwide step up the pressure in the battle against inflation. The current 2-year US Treasury bond yield stands at 4.75%, discounting further rate hikes until the first quarter of 2023. A similar picture can be found in Europe. But the recession that we are envisaging is a moderate one, and credit spreads of both low- and high-risk bonds currently prove us right, as they remain below the peaks reached during past economic downturns. One reason is to be found in the strong fundamentals of companies, which are not excessively indebted and hold reassuring levels of liquidity. Valuations on the other hand cannot be considered unanimously cheap; investment grade issuers are trading in the 90th percentile, which makes them attractive, especially on shorter maturities (the return per unit of maturity is the highest in the 1-5 years bucket). Conversely, both high yield and emerging markets issuers look more expensive on a risk-adjusted basis, and the rise in default rates that frequently accompanies an economic slowdown calls for prudence.



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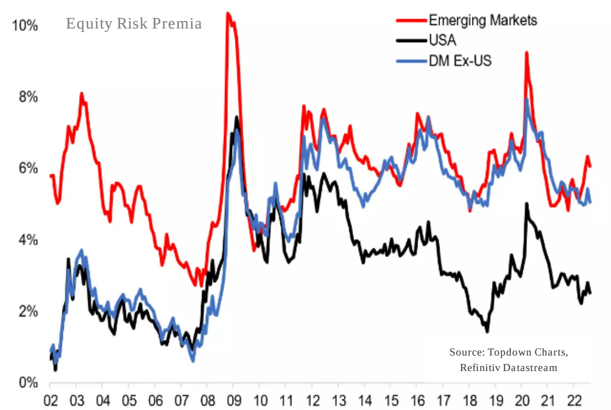
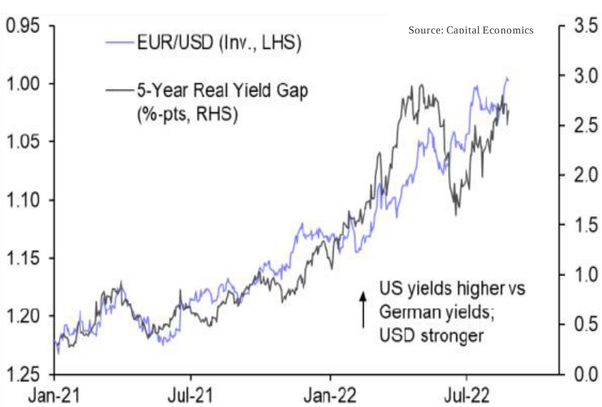
EQUITY: LOOKING FOR A BOTTOM

The latest bout of volatility in financial markets has sent equity indices back towards the lows experienced during the summer – in some cases, for example in Europe, making new lows. At the time of writing, major equity indices are down between 20% and 35% since January 1st. Despite the drop in prices, valuations are not yet attractive, at least not across the broad spectrum; US indices remain above long-term averages, while Europe and Emerging Markets are becoming attractive, in both relative and absolute terms.

The reporting season that is about to start may provide a reason for a technical rebound, supported by the possibility that interest rates may have plateaued, at least temporarily (falling rates are usually positive news for equity prices). Earnings estimates for the third quarter have been downgraded on the back of a slowing economy and rising prices, but the calendar year earnings forecast have not fallen materially, which is surprising considering the challenges consumers and businesses are faced with; beating expectations will not be plain sailing, but history shows US businesses are extremely resilient. Extending the analysis beyond the next quarter, sky-high profit margins, rising input costs, tightening financial conditions, and a falling demand will weigh on companies' earnings. Part of it is already discounted in today's valuations, but the unknowns regarding a possible recession and its severity, as well as the risks associated with the war in the Ukraine, require a degree of caution when investing in risky assets.



COMMODITIES AND CURRENCIES: THE USD TAKING THE CENTER STAGE



A very strong dollar and a slowing global economy is a challenging environment for commodities. No surprise then to see many of those back to square one. Some analysts think of this as the beginning of a new commodity super-cycle, as many years of subpar investments will result in a structural supply deficit for many raw materials. While it is undeniable that firms have been very conservative on capital expenditure, we are yet unsure whether the demand will be strong enough to support such a new paradigm shift. Shorter term, excluding energy prices which are heavily influenced by geopolitical events, commodity prices may remain under pressure as demand will suffer from the current difficult environment.

On the other hand, this is fertile ground for dollar strength, as it is often used as a safe-heaven asset. Moreover, the differential between US and rest-of-the world real yields (the difference between nominal yield and inflation) continues to play in favour of the greenback, at least for a few more months. Longer-term, once the European energy crisis dissipates, we expect the EUR to regain its ground, taking advantage of the same tailwinds that are currently backing the USD. An honorable mention goes to the CHF, which has crossed the parity against the EUR, supported by safe-heaven demand, and the surprising hawkish moves by the Swiss National Bank. Its aggressive stance is helping the economy to keep inflation in check. Long term, valuations point to a weakening of the Swiss currency, but as long as the general environment remains challenging, the turnaround will not emerge.

OUR STANCE

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

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