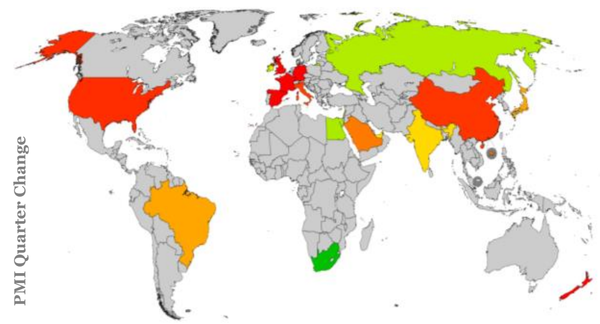
MARKET OUTLOOK

2023/September

ECONOMY: A SILENT *MEA CULPA*

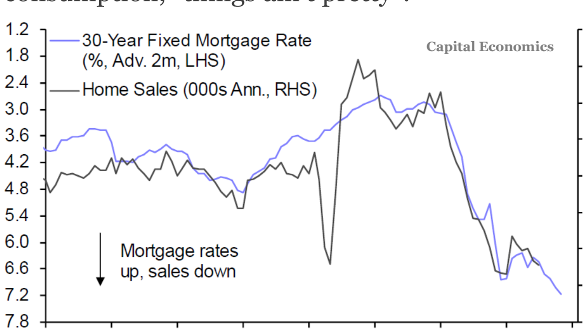
> "*Whenever a theory appears to you as the only possible one, take this as a sign that you have neither understood the theory nor the problem which it was intended to solve.*" – Karl Popper, philosopher.

We have often lambasted at the Federal Reserve (FED) for being too late in adjusting its monetary policy, especially when a mutating economy required increased flexibility and responsiveness. However, now that it has officially landed on Instagram (https://www.instagram.com/federalreserveboard/), we are confident this will surely change…Jokes aside, during the years where the environment was characterized by the famous, and now vanished, acronym **ZIRP** – zero interest rate policy – we noted that such policy was creating excesses that were not visible to the naked eye, but that one day would have backfired, catching all of us off-guard, with adverse effects on both the economy and financial markets. Last year, we also pointed out that inflation had little resemblance to a transitory phenomenon, and that the FED was taking a huge risk in not intervening in what could have only been described as an overheating economy.

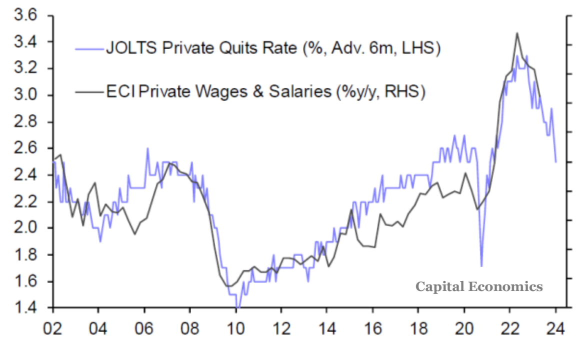


Of course, in hindsight many of us master the various facets of both the economy and financial markets; in hindsight, *we all are successful central bankers*. Hence, today I would like to acknowledge the extreme difficulties the FED faces when confronted with an economy that, since the Great Financial Crisis (GFC), has never been so **uncertain** to read. It simply continues to send contradicting signals. Admittedly, had Mr. Powell acted sooner in curtailing inflation, or had the FED avoided the blow-up of its balance sheet, perhaps we wouldn't be having this discussion. But again, in hindsight…

Let's try to put things in order. The **global** economy is already in a recession. This does not mean the world real GDP growth is negative; it certainly is not. But it is lower than 2%, which international standards define as a recession. The U.S.A. are currently growing above this rate, but according to the latest Purchasing Managers Index (PMI – a monthly survey run across the country to taste the feeling of the companies' top management regarding the economic outlook), we are flirting with a recession, and this is no news. What is interesting is the evolution of the PMI, which has been deteriorating constantly over the past quarters. Not encouraging. Consumption, measured by retail sales, the pillar of the American economy, remains resilient, but it is showing a few cracks; in August it stagnated, alongside a rise in new delinquency rates across the various buckets of expenditure (auto, credit card, mortgage, etc.). To this, one must add that the student loan forbearance is coming to an end, increasing the pressure on the monthly expenses for many Americans. Thus, from the perspective of consumption, "things ain't pretty".



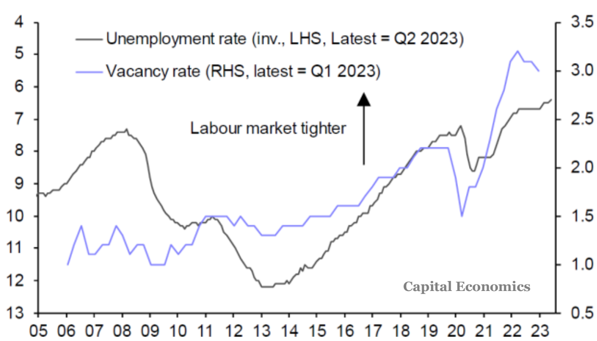
Sticking to the grimmest part of the economy, the activity in the housing market is expected to decelerate considerably as new mortgages become less and less unaffordable. The 30-years mortgage rate is now close to 8% (latest figure), which means most Americans are disincentivised to sell the current home to purchase a new one, as they would give up an attractive rate in exchange for a financial blood bath. Despite a falling demand, house prices remained elevated thanks to a structural **undersupply** of homes, the result of the deleveraging post-GFC. Still, we expect house prices to begin contracting soon as falling demand will outweigh subdued supply. This should put further pressure on the inflation rate, which has been trending lower for some time, towards the 2.0% target the FED looks to achieve.



With these preconditions, it would seem fairly simple to infer what is needed from the FED to avoid a recession and help accommodate a soft-landing; rate cuts. Unfortunately, because the other half of the economy is doing astonishingly well, it is with high probabilities that the former will remain an illusion. The labour market continues to be very strong; admittedly, the quit rate has been falling since its peak during the summer months, while the unemployment rate began to rise, but both measures remain **robust** compared to previous standards. There is still a significant mismatch between labour supply and labour demand. This is the reason why private wages and salaries continue to increase at a rate (4.5%) that is far above what the FED is deeming as acceptable. The FED needs to destroy job demand, and cutting rates surely will not achieve that goal.

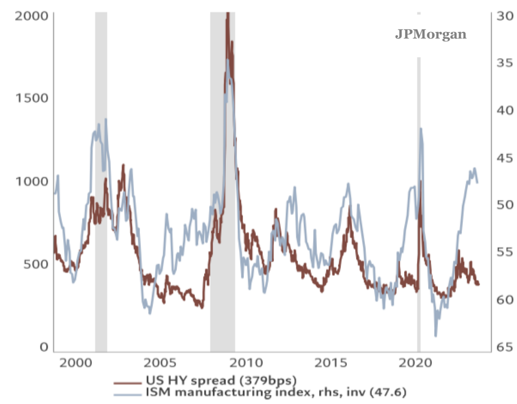
Secondly, while inflation continues to trend lower, we have frequently asserted that the hard part is still ahead of us. In all honesty, a big chunk of the spike in inflation witnessed in 2022 was related to supply-side effects, and these have almost entirely faded by themselves. Bringing the current 4.3% core inflation to the target of 2.0%, in an environment characterized by a stretched job market, labour unions on the war path, and energy prices on the rise again, will not be "easy-peasy". Again, we suspect it will require an extremely hawkish FED.

Finally, the fiscal **indiscipline** of the US Federal Government (no matter from which side) who, by constantly running bottomless budget deficits, is replacing the consumer in upholding the economy, is proving to be a double-edge sword; on the one hand, it is postponing the day of reckoning but on the other, it is forcing the central bank into persevering down an hawkish path. Lax fiscal policies and easy monetary policies were the main causes of today's excesses, thus it is unlikely the FED will embark on a similar journey anytime soon. "Higher for longer" is the mantra for the foreseeable future. We suspect the FED will only change plans once the economy has set way for a recession. Several rounds of interest rate cuts will not modify the course of events, as it often never did in the past. But, given the extremely complex macroeconomic scenario, even *the most successful central banker* could have missed this one.



In Europe, the situation is as mind grasping as overseas, with the caveat that the growth engine (i.e. Germany) has already flooded due to the recessionary state of the manufacturing sector and the pressure coming from higher energy prices. The services industry, notably at the heart of the economic growth of the Southern countries, has helped towing the cart, but we doubt this can continue for long, as excess savings continue to gradually fade, and the bite from higher (seriously higher!) prices is being felt across any product or service that is consumed. No support will come from monetary authorities, as inflation is just off its peak (core inflation at 4.5%) and may continue to hover above what is considered an acceptable level by the European Central Bank. Truly an opposite scenario to Switzerland and China, where inflation is back below the 2% level, accompanied by GDP growth expectations that are lacklustre, at best. Both countries, meaningfully export-dependent, suffer from the global economic slowdown, but the Swiss economy is much more **resilient** (e.g. the unemployment rate reached a peak of 4% during the GFC, while averaging 3% over the past thirty years). On the other hand, China's real estate sector continues to act as a drag to the economic recovery, with house prices in freefall since the beginning of 2021. As we wrote in the beginning, excesses take time to build and are often invisible, until they are not anymore, at which point it is too late to act, and one can only clear them with patience, accepting the fallouts.

FIXED INCOME: THE FULCRUM OF THE ATTENTION



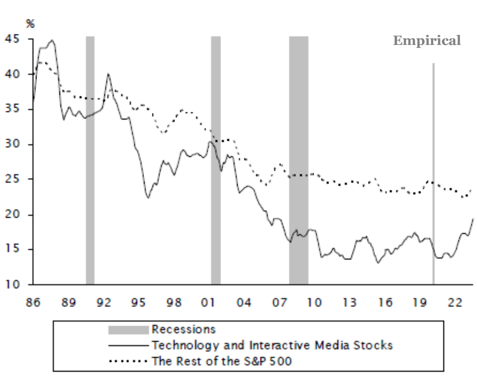
No compromises. It's either ZIRP or RIRP (restrictive interest rate policies). Surprisingly, because net of the excesses we are in the process of removing, the world does not look very different from the pre-pandemic era (artificial intelligence will excuse us for the time being). Still, long-term USD interest rates are close to 5%; looks like a bargain, probably it is not…yet. This is because the **irrationality** was *back then*, not today. But aside from rhetoric, we believe it is a good time to start thinking about increasing the duration of the portfolio. Not with high yield bonds, which have performed egregiously this year, but seem expensive to us (they seemed expensive already at the beginning of the year), especially compared to an economic outlook that is far from reassuring and a maturity wall that looks difficult to climb (i.e. almost 10% of the global high yield maturities must be refinanced during the next couple of years, and the refinancing rate will be much different compared to the current interest expense). Rather, we suggest **high-investment grade** corporate bonds, which comprises issuers that carry low leverage, high expected cash flows, and fair valuations. Will their prices fall in case of a recession? Probably. Will the bonds default? No. And the current returns you can lock in, gross of taxes, is in the 6% area, by taking only a modest duration risk (estimated at around 4 years).

We suspect the FED will only change plans once the economy has set way for a recession.

A similar picture is portrayed by the European fixed income market, but one needs to lower all the expected returns by approx. 2%. Given our rather conservative view, we suggest avoiding the Southern hemisphere, where both government and corporate bonds don't do particularly well (in relative terms) during recessionary environments. Finally, on emerging markets (can we really group them as one single *Continent* anymore?), we see valuations as being unattractive compared to their long-term average, and because we expect a stronger USD in the foreseeable future, we believe emerging market investors must keep their helmet on for some time. However, expected returns are starting to look **appealing**, especially among local currency issuers, as many emerging markets currencies have suffered the strength of the USD, but the related economies have cleared the burden of excessively high inflation rates.

EQUITY: VALUATIONS, VALUATIONS, AND…VALUATIONS

Let's turn to the intriguing stuff. Since our last quarterly commentary, global equities have lost approx. 3%, excluding dividends. Not devastating, but it marks the second consecutive quarter of sluggish global returns. Looking back, if you were not invested during the first few weeks of the year, most likely you would have made no money. More interestingly, if you are a stock picker and you had not purchased the ***magnificent seven*** (Apple, Amazon, Meta, Alphabet, Nvidia, Tesla, and Microsoft), chances are you would have made no returns either (the return excluding dividends of the S&P 500 equal-weight index is -1.5%). Little market breadth is usually not a sign of healthy equity markets.



We mentioned earlier that consumption is set to slow further from this point on thus, we could expect revenue growth to disappoint during the next few quarters. To maintain the (whopping) earnings (EPS) growth analysts expect for the next few years, margins would need to widen. But can they really?

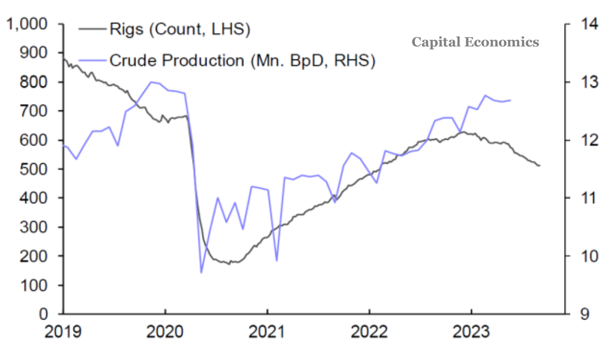
Over the past decade, the aggregate profit margin of the S&P 500 index has grown mainly because of three factors: the expansion of the capital-light sectors (technology and communication services), persistently low interest rates, and falling tax rates (via tax sheltering). Going forward, capital-light sectors can surely take on a further share of the index, but rising **competition** should limit their ability to keep margins where they are today. No company can grow at high double-digit indefinitely. Secondly, persistently low interest rates don't exist anymore, at least for now. Once companies refinance their debt, interest expenses will automatically increase. Thirdly, we note there has been a race to the bottom among governments worldwide, to grab a share of the profits of multinational companies looking to relocate for tax purposes. However, in an environment where money is desperately needed to avoid the ballooning of the budget deficits, we are inclined to believe we have reached, or are close to, the end of the line. All of this to say that we find the current expected EPS growth rate far too optimistic.

Adding fuel to the fire, current equity valuations are expensive, **despite** too rosy EPS growth expectations. If we were to normalize EPS growth forecasts, valuations would suddenly become…unjustifiable (reminder: in the forward Price/Earnings multiple, a valuation metric often used in finance, the denominator is based on expectations. If you lower it, the multiple increases, making valuations more expensive). Add to this that you can receive around 6% by lending your capital to companies with healthy balance sheets (i.e. low risk), and suddenly investing into stocks does not look so attractive anymore (the long-term average annual total return of the S&P 500 is approx. 7%).

In Europe and Switzerland, everything looks more modest; expected EPS growth is less buoyant, margins are not extreme and currently falling, while valuations are slightly cheaper (there are a few exceptions, such as certain defensive Swiss sectors, which command a premium). We reiterate our view that European and Swiss stocks, on average, could outperform global indices during a prolonged correction. More broadly, defensive sectors such as consumer staples and health care, which offer good visibility in terms of future cash flows, as well as energy stocks, which have very cheap valuations and offer enormous cash generation capabilities, are among our best picks for the current environment.

CURRENCIES AND COMMODITIES: RETURNS *BY THE BOOK*

Over the quarter, the USD index has appreciated by roughly 3%, the best run it had in over a year. This was the result of yield spreads rising in favour of the greenback, as well as a pull-back in risk sentiment. Conversely, both the EUR and the CHF suffered a few setbacks against global currencies. Our stance has not changed; we think the USD will continue to act as a counter-cyclical currency, and thus should appreciate during times of economic contraction and/or financial stress. That said, based on valuations and the inability of any U.S. government to keep a fiscal discipline, we see the greenback further depreciating over the long term. But more generally, this remains a battle among the **weak**, with developed economies facing expanding debt/GDP ratios, elevated central banks' balance sheets, and fiscal imbalances. A good environment for gold and perhaps Bitcoin, which carries very similar characteristics to the yellow metal, except the fact it has been around for only ten years and thus still needs to prove itself as the contemporary, digital safe-haven asset.



More cyclical commodities have unsurprisingly continued to suffer in the third quarter as global growth slowed. Industrial metals are down roughly 15% since the beginning of the year and have very little upside potential until the situation in China improves. A clear exception is the price of oil, which increased by almost 25 $/barrel during the quarter, before experiencing wild **swings** over the past few days, resulting in a correction of over 10%. A lot of the price move is currently driven by geopolitical factors, which are hard to predict. We tend to believe that the price of oil will remain range-bound for some time, on the back of falling demand more than compensated by declining drilling activity in the U.S.A.

OUR STANCE

Liquidity: Underweight	**Bonds**: Equal Weight	**Equities**: Underweight	**Alternatives**: Overweight	**Commodities**: Overweight

CONTACT US:

LFA – Lugano Financial Advisors SA
Via F. Pelli 3
6900 Lugano, Switzerland
O. +41 91 922 69 18
borghesi@lfa.ch
www.lfa.ch

DISCLAIMER

This investment report prepared by Lugano Financial Advisors SA ("LFA"), contains selected information and investment opportunities identified by LFA. This document is based on sources believed to be and reliable, accurate and complete. In particular, LFA shall not be liable for the accuracy and completeness of the statements estimates and conclusions derived from the information contained in this document.

Any information in this document is purely indicative. This document is not a contractual document and/or any form of recommendation. It does not constitute an offer, a solicitation, advice, or recommendation to purchase, subscribe for or sell any financial instruments.

Under no circumstances, LFA shall be liable for any kind of damages, direct, indirect, or non-contractual. Prices and rates indicated are subject to change without prior notice. The investments are valued at the market price as of the investment reporting date (e.g. stock exchange closing price, Net asset value or market maker price). Should no market price be available as of the investment reporting date, LFA shall use the last available price for the valuation.

LFA shall assume no obligation to purchase or sell the investments at the reported market prices. The data provided in this investment report, which do not specifically refer to the account and custody account positions of the client, are intended solely for the client's own use and may not be passed on or used independently of the client-related data stated in this investment reporting. Reliance on the data contained in this investment report and any resulting act or omission on the part of the client or third parties shall be at the client's or third party's own risk. Past performance should not be seen as an indication of future performance.

This investment report is not intended to be used for tax purposes.

Please check this investment report and inform LFA of any discrepancies within 4 weeks.