Investment letter

Monthly review of global financial markets

SWISS CAPITAL IB

OCTOBER 2022

MACROECONOMICS

Inflation was, again, the biggest worry macro-wise throughout September. **In the Eurozone**, September headline inflation marked another historical high at 10.0% while core inflation (excluding energy and food prices) rose to 4.8%. **In the US**, August inflation surprised significantly on the upside. The print was mainly a "core" story as energy prices were down 5% on the month thanks to an 11% plunge in gasoline prices while core inflation climbed to 6.3% year-on-year. The key driver was shelter, which represents roughly 40% of the core basket, and is among the stickiest and most lagging components of inflation. Given the meteoric rise in mortgage rates and subsequent fall in home affordability, shelter prices will inevitably slow at some point. Unfortunately, its persistence is difficult to assess, keeping the US Federal Reserve (Fed) on a very hawkish path in the short term. **In the UK**, inflation came out just shy of 10% for August, with dire expectations given the highly inflationary impact of the hefty tax cuts announced towards the end of the month.

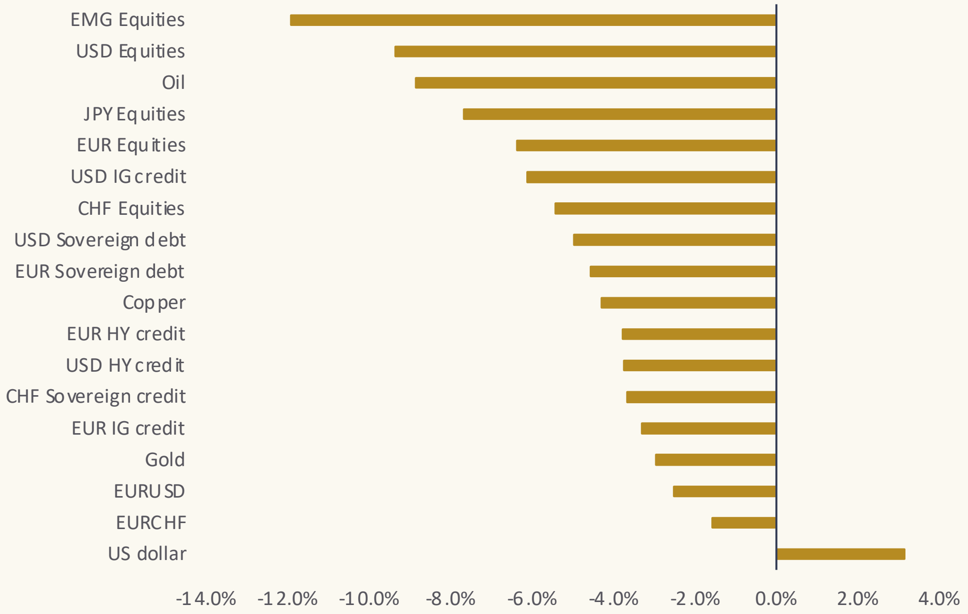
> "The focus will turn from inflation to recession risks sooner than most expect"

As a result, central banks are all-in with a global assault on inflation. Following a 75bps hike to 3%-3.25% in September, the Fed signaled a 4.6% terminal rate with no cut before 2024. The European Central Bank raised its key interest rates by 75bps for the first time in over two decades in September, taking the depo rate to 0.75% with significant upward revisions to its inflation projections. The Bank of England delivered a second consecutive 50bps hike to 2.25% and will have to double down on its efforts given expansionary fiscal policies and collapsing currency. The Swiss National Bank (SNB) raised its policy rate by 75bps, to 0.5%, stating that further rate hikes "cannot be ruled out" to ensure medium-term price stability. That said, we note that the SNB is in a much better place than most central banks worldwide as it welcomes a strong currency, inflationary pressures remain reasonable, and it can finally exit negative interest rates.

Every story is specific, but inflation clearly is a global 2022 phenomenon. We acknowledge that the fight is not fully over, but we strongly believe that the focus will turn to recession risks sooner than most expect, and policymakers are now more at risk of "over"- rather than "under-doing" it.

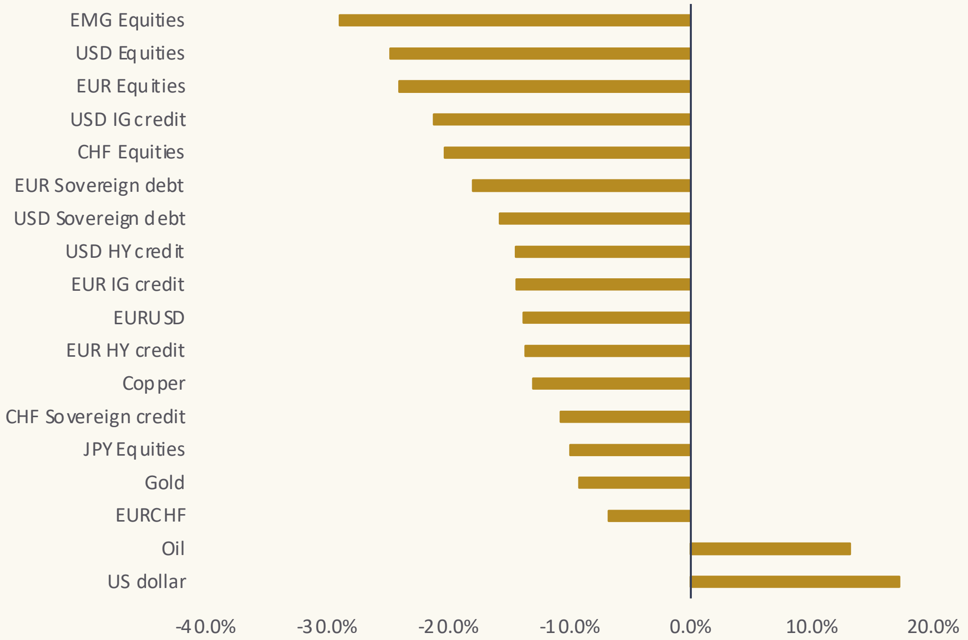
OVERVIEW

MAIN ASSET CLASSES
MONTHLY PERFORMANCE



Source: Bloomberg, from 31/08/2022 to 30/09/2022

MAIN ASSET CLASSES
PERFORMANCE YEAR-TO-DATE



Source: Bloomberg, 30/09/2022

MACROECONOMICS (continued)

The US is one of the most resilient economies with August ISM indices (monthly indicators of economic activity) still in expansion territory. However, it is just a matter of time before surging real rates dent economic activity with higher cost of capital hitting both businesses and consumers. In addition, housing – which is roughly half of the wealth of close to 90% of the population – will slow before long given surging mortgage rates. In the Eurozone, most economic indicators are already consistent with an upcoming recession, including retail sales, consumer confidence or purchasing manager indices.

Our view is that central banks will remain aggressive in the short-term, raising rates until something breaks, with a terminal rate likely between 4 and 5% in the US, and between 1.5% and 2.5% in the Eurozone. But we believe that central banks will cut rates sooner than they communicate, around Q3/Q4 2023 in the US, and likely even earlier in the Eurozone.

Inflation was a 2022 story; it is now time to position for recession.

Recession looming

EQUITY MARKETS

Equity indices vulnerable to short term rally, but too early to add risk

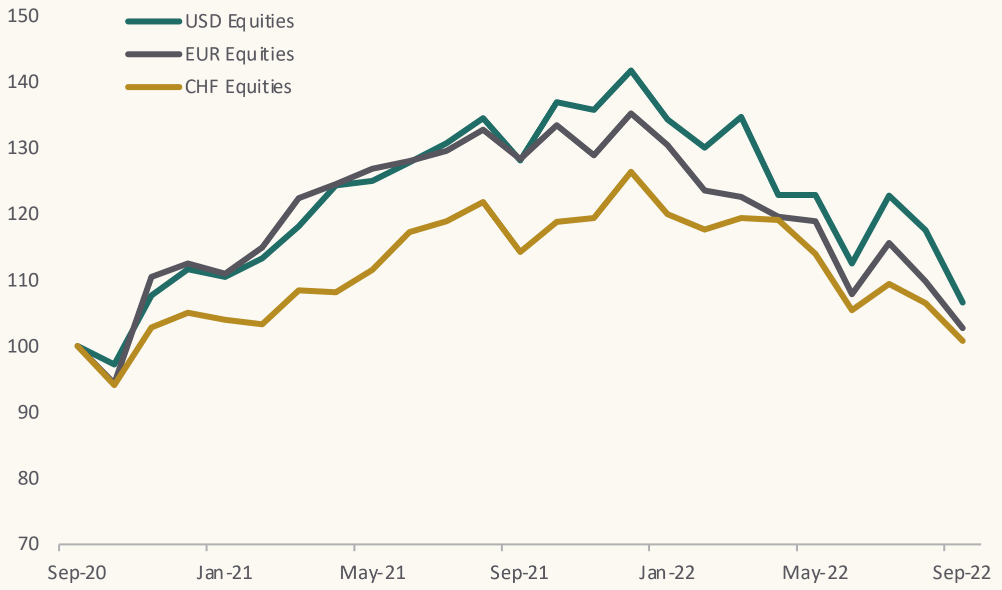
While multiples are getting cheaper, we think they are not cheap enough in the context of still aggressive central banks. The S&P 500 Price-to-12m forward earnings multiple could derate from 16.7 at the time of writing to 15x given expected inflation and yield levels. This would take the index down to 3450, barring downgrades for 2023 EPS consensus.

In Europe, we acknowledge that sentiment and positioning are extremely bearish. However, without policy pivot and/or earnings reset, this can only generate bear market rallies

We still need patience before adding to cyclicality. We stick to our low beta and quality strategies as they offer earnings visibility and balance sheet solidity in a deteriorating macro environment.

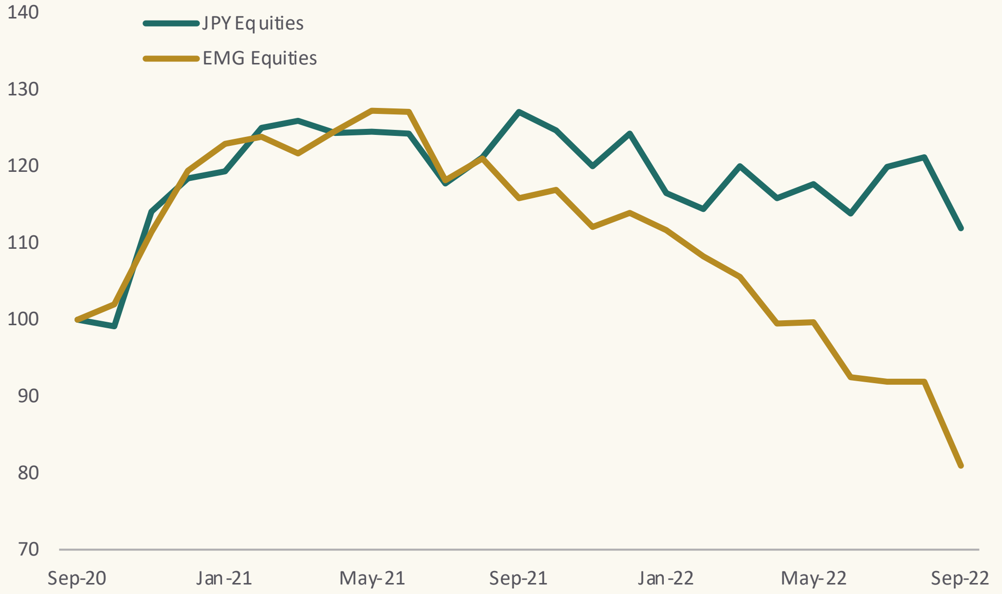
EQUITY MARKETS

EQUITY MARKETS EUR USD CHF
PERFORMANCE OVER 2 YEARS



Source: Bloomberg, 30/09/2022

EQUITY MARKETS JAPAN – EMERGING MARKETS
PERFORMANCE OVER 2 YEARS



Source: Bloomberg, 30/09/2022

BOND MARKETS

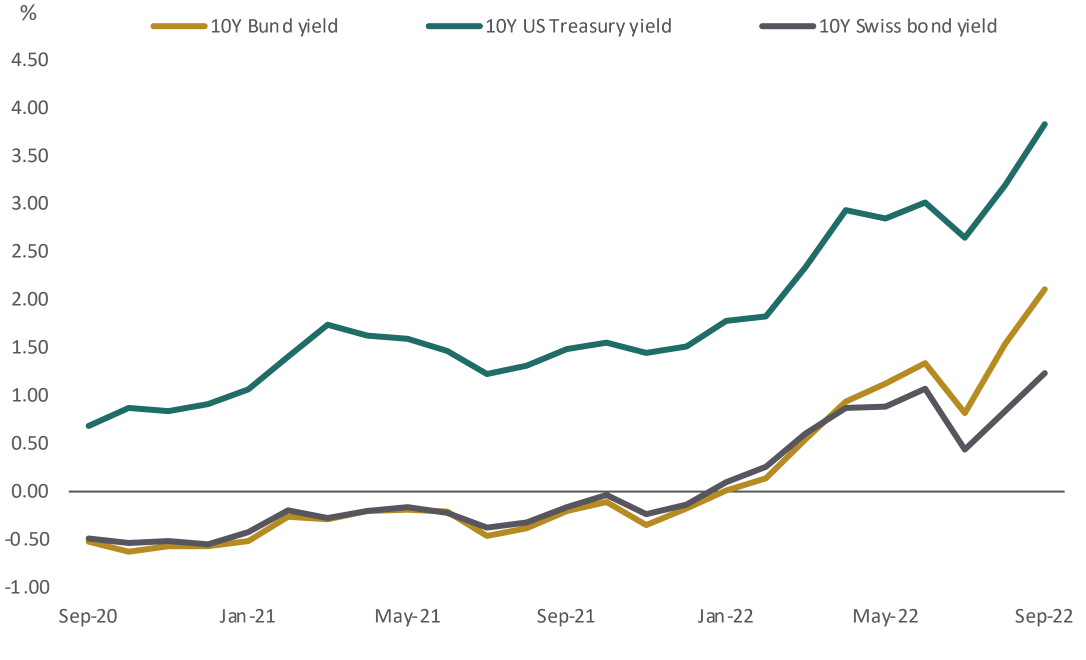
Given deteriorating global liquidity conditions while earnings and growth risks are intensifying, increased dispersion is on the cards, still warranting selectiveness within **credit.** We prefer liquid non-cyclical EUR investment grade, financial credit, and supra-sovereign agencies. Indeed, increasing cost of capital is highly likely to stress the most vulnerable entities such as highly levered governments, companies, and households.

Within **sovereign bonds**, Gilts saw extreme moves at month-end as the new government's mini-budget focused on unfunded tax cuts, which bond vigilantes are unlikely to tolerate. In this context, future Italian budget stances from the new coalition should be closely watched, although it signaled a constructive stance with the EU so far. We remain overweight US Treasuries, core European government bonds and supra sovereigns.

With global yield curves reaching extreme inversions and markets pricing of peak policy rates likely correct, we believe it may be time to position for **rate curves bull steepening.**

"Buy high quality bonds"

10Y SOVEREIGN BOND YIELDS
EVOLUTION OVER 2 YEARS



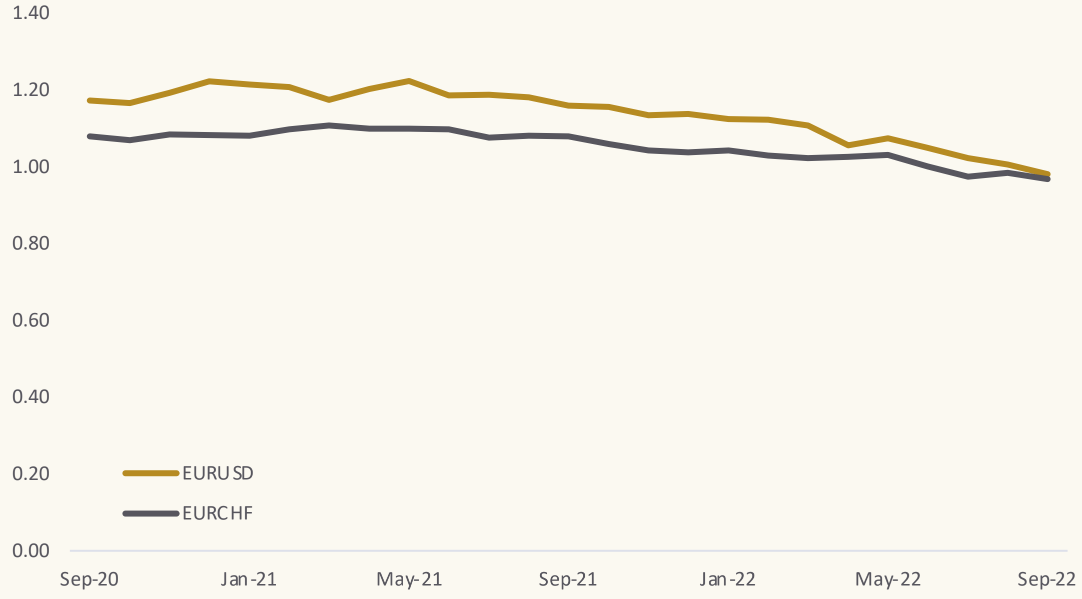
Source: Bloomberg, 30/09/2022

CURRENCIES

The USD continued to rise in September with a more aggressive Fed and lingering vulnerabilities outside the US. Despite its historically high level, conditions are not in place yet to short the USD.

EUR below parity is already pricing in a lot of bad news. Negative growth surprises in the US and a better-than-expected resilience to the energy crisis would limit the downside from here. On the other hand, the GBP collapse in the wake of poor fiscal policies is justified. We would not call for much higher GBP at this stage. Finally, the Japanese Yen story is unique and intimately linked to exceptionally muted inflationary pressures. As discussions around a Fed pivot intensify, the JPY could retrace significantly from current levels.

USD & CHF
EVOLUTION OVER 2 YEARS AGAINST THE EUR



Source: Bloomberg, 30/09/2022

COMMODITIES

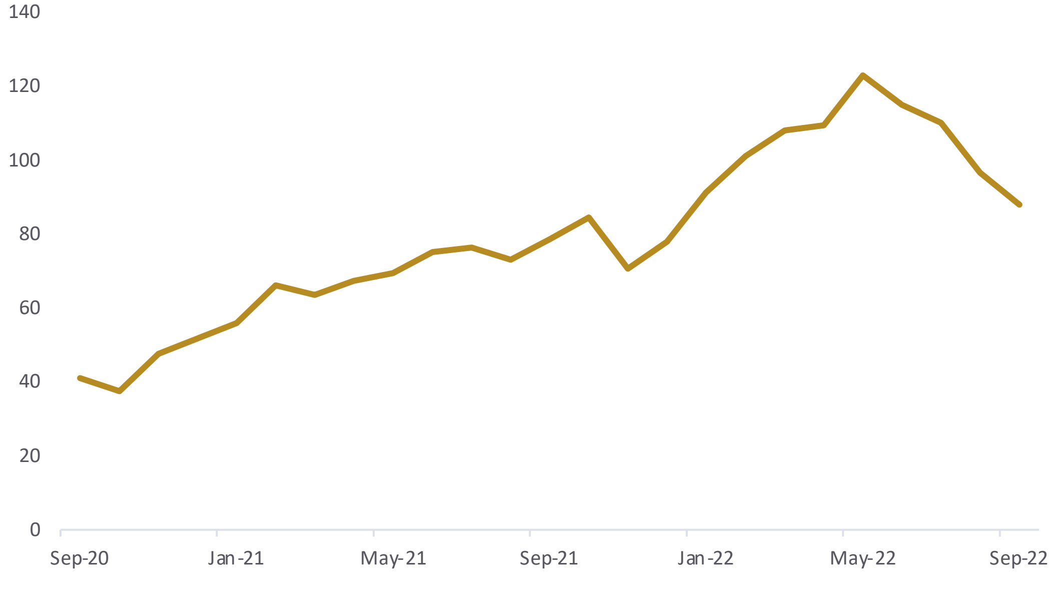
OIL

Oil continued to slide in September as slowing demand is starting to outweigh the positive impact on prices from limited production. Given heightened recession risks, the medium-term outlook remains bearish, although geopolitically-induced spikes cannot be ruled-out.

Slowdown prevails

Nord Stream 1 flows have been suspended indefinitely since early September, with the European benchmark TTF briefly spiking above 300EUR/MWh. Prices have eased somewhat since then, but lower pipeline flows into Europe will necessitate further demand destruction, meaning that gas prices will likely stay elevated in the quarters to come.

OIL
EVOLUTION OF BRENT PRICES OVER 2 YEARS



Source: Bloomberg, 30/09/2022

COMMODITIES

GOLD

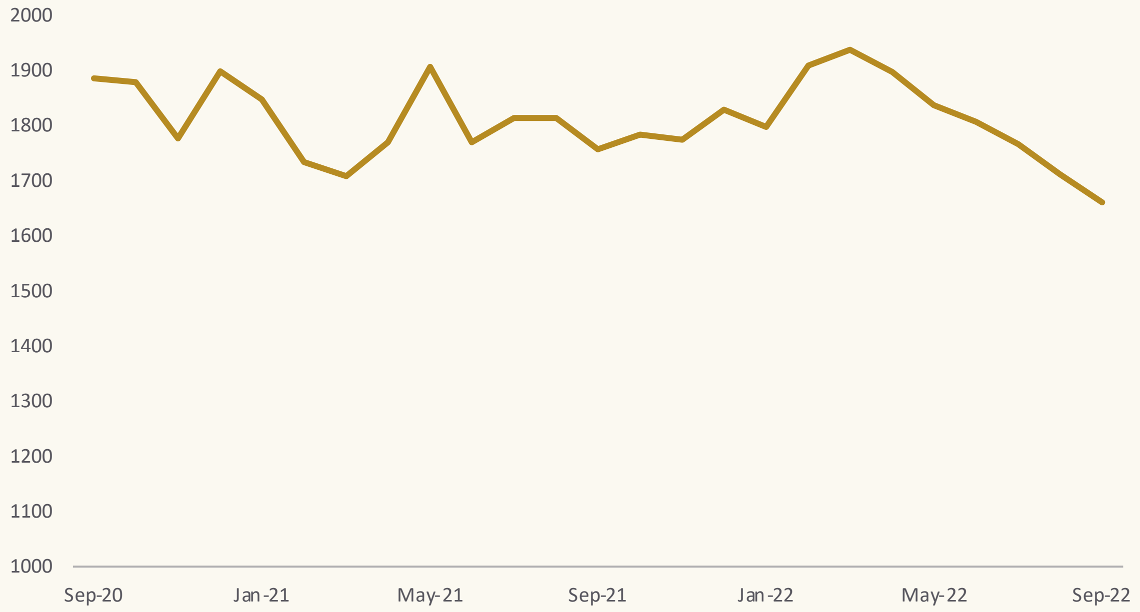
Gold fell in September amid dollar strength, higher real rates and an even more hawkish Fed's tone.

In the short-term, central banks' determination to raise rates aggressively means that the yellow metal may suffer further.

Lower real rates would be needed to increase the relative benefit of owning Gold. As such, we would expect the Fed pivot to consider a Gold exposure.

No shine when real rates rise

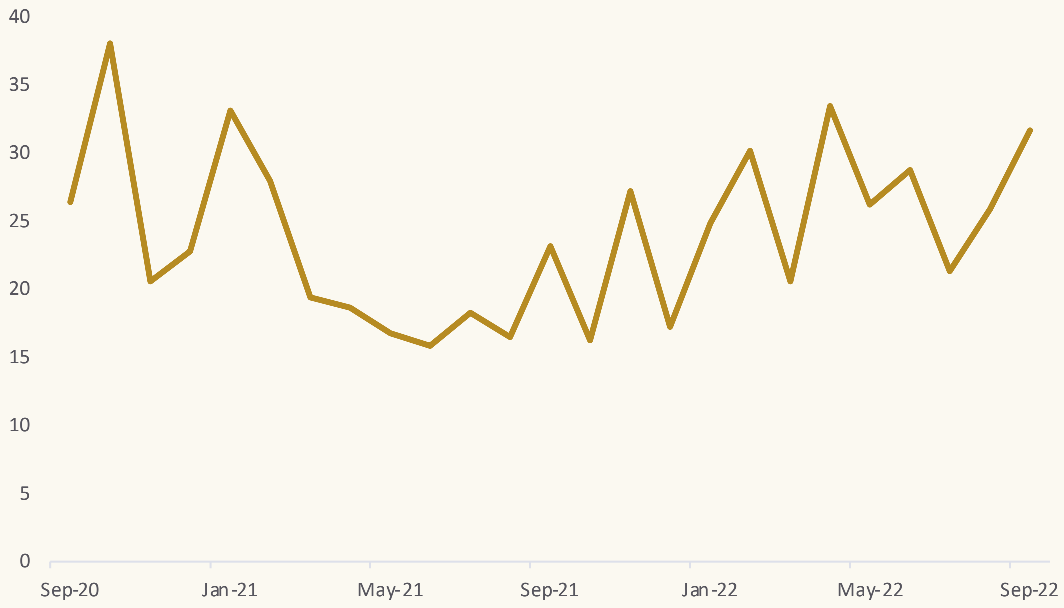
GOLD
EVOLUTION OVER 2 YEARS



Source: Bloomberg, 30/09/2022

VOLATILITY

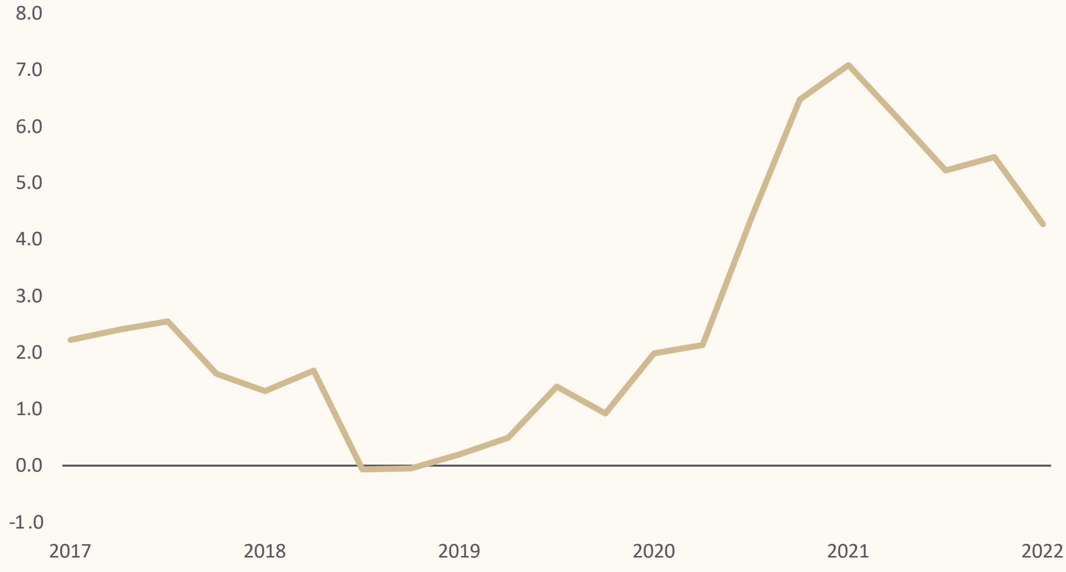
VOLATILITY – VIX INDEX
EVOLUTION OVER 2 YEARS



Source: Bloomberg, 30/09/2022

REAL ESTATE

SWISS RESIDENTIAL REAL ESTATE
ANNUAL PRICE CHANGE



Source: Bloomberg, 30/09/2022

CALENDAR

Date	Country	Economic Data	Period	Previous
03 October	US	Manufacturing PMI	Sep-22	52,8
	Eurozone	Markit Manufacturing PMI	Oct-22	48,4
	UK	Markit Manufacturing PMI	Oct-22	48,4
	Japan	Nikkei Manufacturing PMI	Oct-22	50,8
	Switzerland	Manufacturing PMI	Oct-22	57,1
	Switzerland	Inflation (YoY)	Oct-22	3,3
05 October	US	ISM Non-Manufacturing Index	Sep-22	56,9
	Eurozone	Markit Services PMI	Oct-22	48,9
	UK	Markit Services PMI	Oct-22	49,2
07 October	US	Employment (000s)	Sep-22	315,0
	US	Unemployment Rate (%)	Sep-22	3,7
	Germany	Industrial Production (MoM)	Aug-22	-0,3
	Switzerland	Unemployment Rate (%)	Sep-22	2,1
11 October	UK	Unemployment Rate (%)	Aug-22	3,6
12 October	US	Fed minutes	Mar-23	
	Eurozone	Industrial Production (MoM)	Aug-22	-2,3
13 October	US	Inflation (YoY)	Sep-22	8,3
14 October	US	Consumer Confidence	Oct-22	58,6
	China	Exports (YoY)	Sep-22	7,1
	China	Inflation (YoY)	Sep-22	2,5
17 October	Japan	Industrial Production (MoM)	Sep-22	2,7
18 October	US	Industrial Production (MoM)	Sep-22	-0,2
	China	Retail Sales (YoY)	Sep-22	5,4
	China	Real GDP (YoY)	Sep-22	0,4
18 October	China	Industrial production (YoY)	Sep-22	3,6
19 October	UK	Inflation (YoY)	Sep-22	9,9
20 October	US	Philadelphia Fed Business Survey	Oct-22	-9,9
25 October	Germany	Ifo Business Climate	Oct-22	88,6
27 October	US	Real GDP (QoQ)	Sep-22	-0,6
	Eurozone	ECB Interest Rate (%)	Oct-22	0,8
28 October	France	Real GDP (QoQ)	Sep-22	0,5
	Japan	Bank of Japan Interest Rate (%)	Oct-22	-0,1
31 October	Eurozone	Inflation (YoY)	Oct-22	10,0
	Eurozone	Real GDP (QoQ)	Sep-22	0,8
	Germany	Real GDP (QoQ)	Sep-22	0,1
	Italy	Real GDP (QoQ)	Sep-22	1,1
	Switzerland	KOF Leading Indicator	Oct-22	93,8

LET'S TALK ABOUT IT.

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