Investment letter

Monthly review of global financial markets

SWISS CAPITAL IB

SEPTEMBER 2022

MACROECONOMICS

The sharp summer equity markets' rally seems to have peaked this month as investors readjust to a bleak underlying macro reality.

In the US, housing activity keeps slowing with new home sales falling 12.6% in July, which, along with rising supply, points to falling prices ahead. With real estate representing roughly half of the wealth of 90% of the American population, it is a matter of time before the housing cycle slowdown translates into lower consumer demand more broadly. The August services flash PMI coming out at 44.1, lowest since May 2020, certainly points in that direction.

The resiliency of the labor market so far contradicts the idea that the US may already be in recession despite two consecutive quarters of negative GDP growth recorded in the first half of the year. But the probability of a mild one in the next 12 months is high, roughly 50%, as it seems challenging for such elevated inflation to fall faster than growth, in turn forcing Fed officials into restrictive policy. We expect the Fed to hike rates to 3.5%-4% by end-2022 or early 2023. Thereafter, cuts will likely not happen before late 2023 as a protracted pause in restrictive territory will be needed to bring inflation down to target.

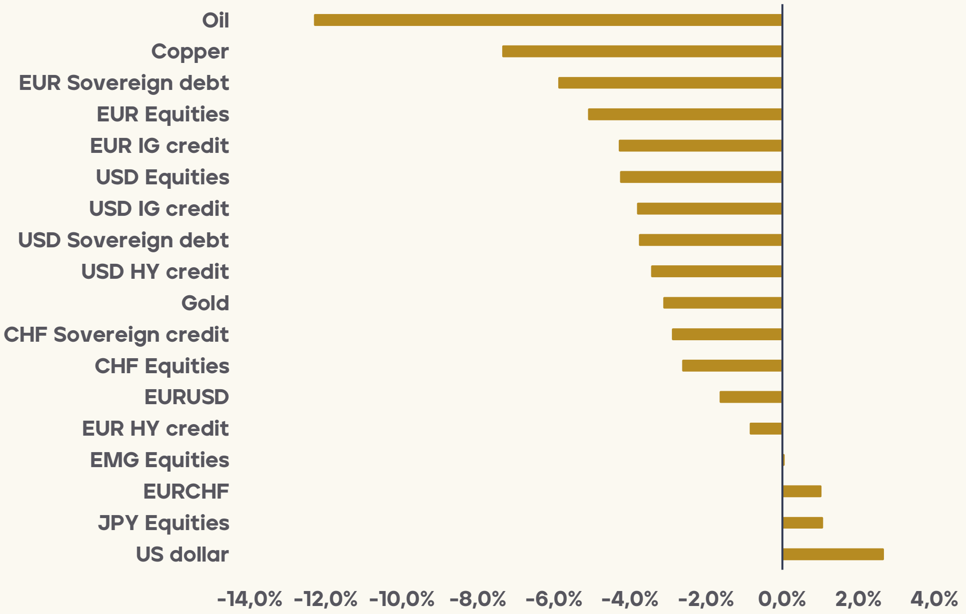
> "the US may enter a mild recession in the next 12 months, while a more severe European recession is likely to come sooner"

Meanwhile, a recession in Europe is now mostly deemed "the base case". The cost-of-living crisis will be painful to beat given external energy dependency, a severe summer drought has led to collapsing water levels, and Italy has entered yet another volatile political cycle. With inflation expected to peak above 10% in the Eurozone, the ECB is on track for another large hike in September, with 75bps now on the table. Whilst markets are priced for a ~2.2% peak mid-2023, we believe the ECB will be stopped out by recession just over 1%.

Finally, China is largely contributing to the global slowdown, as the usual fiscal and monetary levers to kick-start growth are trickier to exploit this time. Muted inflation, weak credit growth, disappointing retail sales, and a sharp property sector slowdown all point to an unequivocal lack of domestic demand, the Achille heel of China's economy.

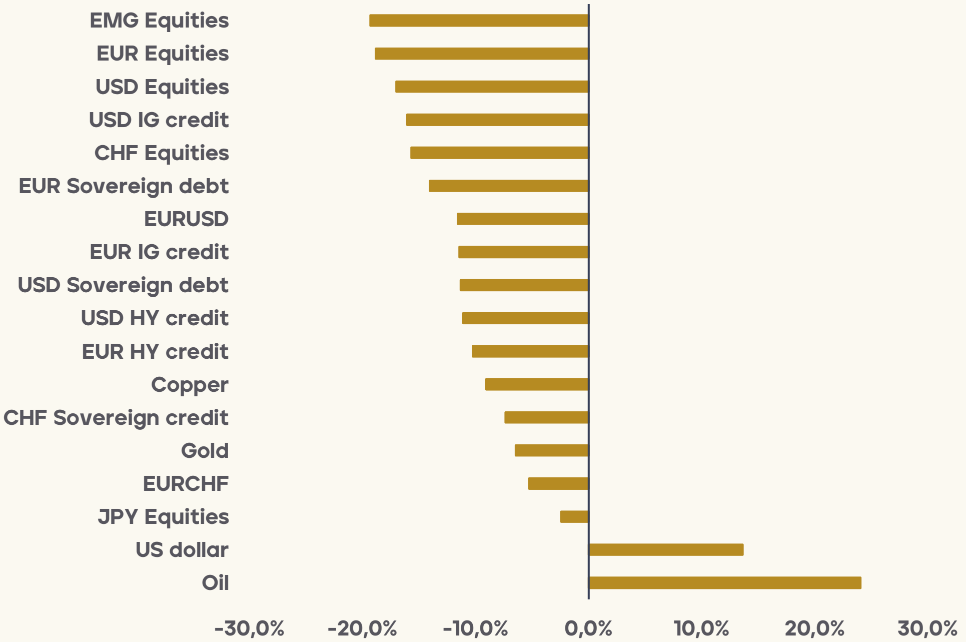
OVERVIEW

MAIN ASSET CLASSES
MONTHLY PERFORMANCE



Source: Bloomberg, from 29/07/2022 to 31/08/2022

MAIN ASSET CLASSES
PERFORMANCE YEAR-TO-DATE



Source: Bloomberg, 31/08/2022

MACROECONOMICS (continued)

Whilst the PBoC surprised markets with policy rates' cuts in August, and Premier Li urged provinces to boost growth measures, domestic demand is unlikely to rebound decisively. Zero-Covid policy is set to perdure at least until the 20th Party Congress in October. Chinese growth is yet again revised down to ~3% in 2022.

All told, whilst inflation will slow as demand softens, supply normalises and policymakers remain determined, avoiding bouts of recession seems extremely challenging.

Recession consensus

EQUITY MARKETS

While we remain cautious on equity markets, we acknowledge that positioning is already hitting extreme levels, especially in Europe where short interest has reached the 95th percentile on the Estoxx 50 and surpassed the Covid March 20 lows on the DAX.

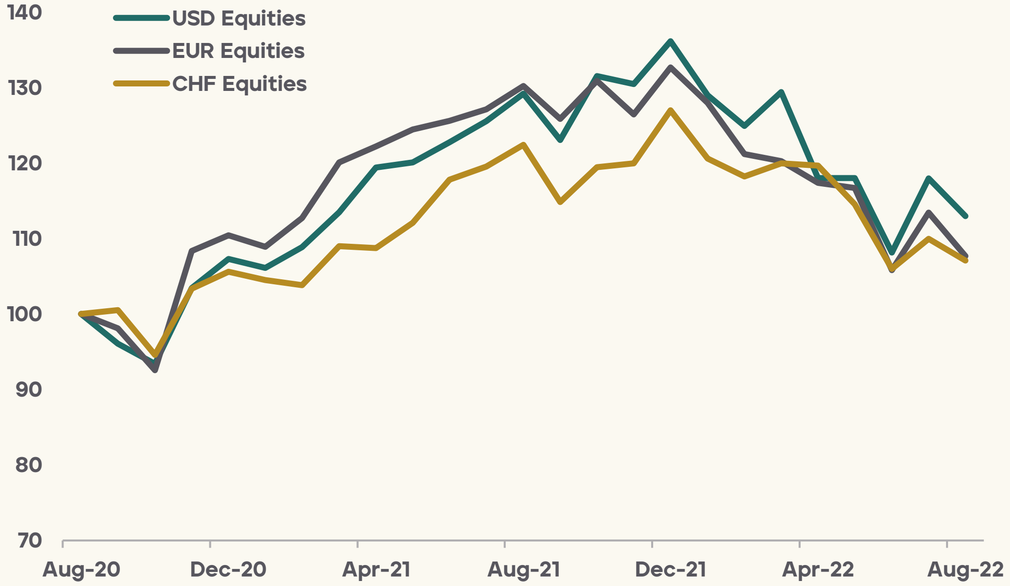
Equity indices vulnerable to short term rally, but too early to add risk

Thus, equity indices are vulnerable to short term rallies, but we maintain our view that it is still too early to add risk as we haven't seen yet the full-blown capitulation that marked past recessions.

We therefore stick to a more defensive approach via low beta strategies and would wait for PMIs to bottom to be more aggressive on cyclicals.

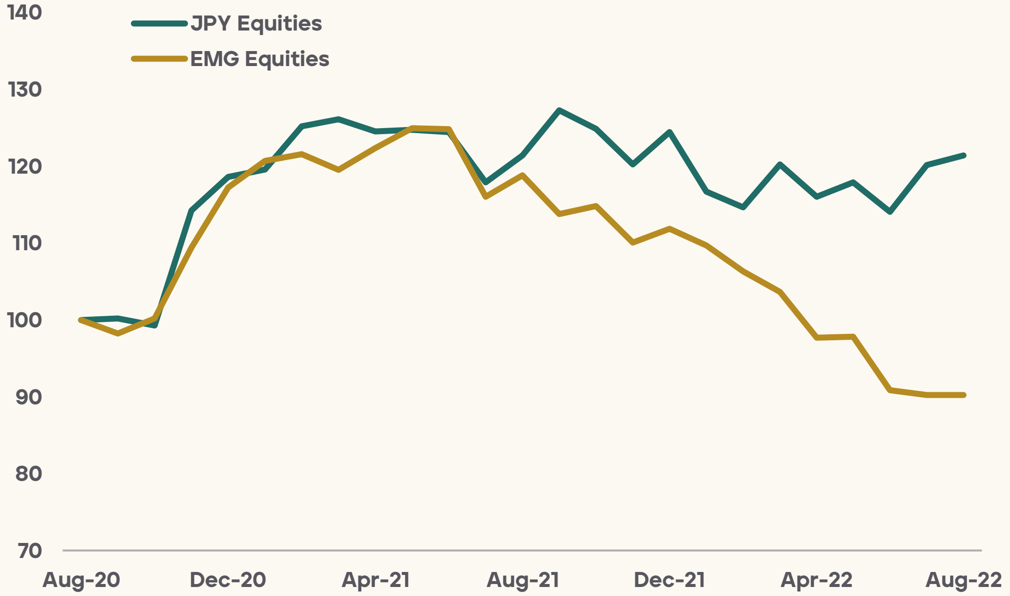
EQUITY MARKETS

EQUITY MARKETS EUR USD CHF
PERFORMANCE OVER 2 YEARS



Source: Bloomberg, 31/08/2022

EQUITY MARKETS JAPAN - EMERGING MARKETS
PERFORMANCE OVER 2 YEARS



Source: Bloomberg, 31/08/2022

BOND MARKETS

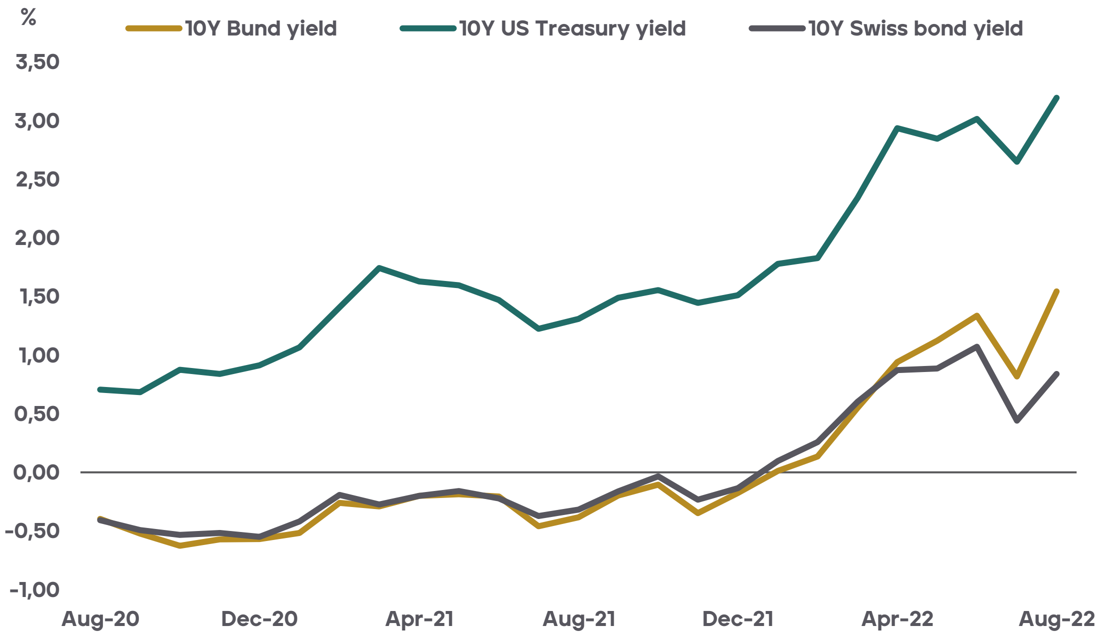
Government bond yields retraced higher as the terminal rate was moved back to the higher end of the range, with central banks' rhetoric remaining hawkish despite increased talks of a Fed pivot during the summer.

The 2v10 UST curve reached its most inverted level of the cycle, just shy of -50bps, before retracing to flat on the month. Despite the yields retracement higher, interest rate volatility isn't seeing the type of spike we saw in Q2 as monetary policy and inflation tail risk are seen as lower. Indeed, breakeven inflation rates continue to slide, in line with the price action in commodities and other leading inflation indicators. This is leaving real rates at cycle highs as the inflation risk premium grows to elevated levels.

Credit spreads widened back towards their year highs as risk assets' momentum and the economic outlook slide. While the HY primary market remains all but shut, August saw record financials issuance volume as the sector retains its fundamental appeal for investors across the capital structure. While such volumes in a difficult technical environment may lead to short term indigestion, the sector offers one of the best risk/reward in global credit markets.

"financials offer one of the best risk/reward in global credit markets"

10Y SOVEREIGN BOND YIELDS
EVOLUTION OVER 2 YEARS



Source: Bloomberg, 31/08/2022

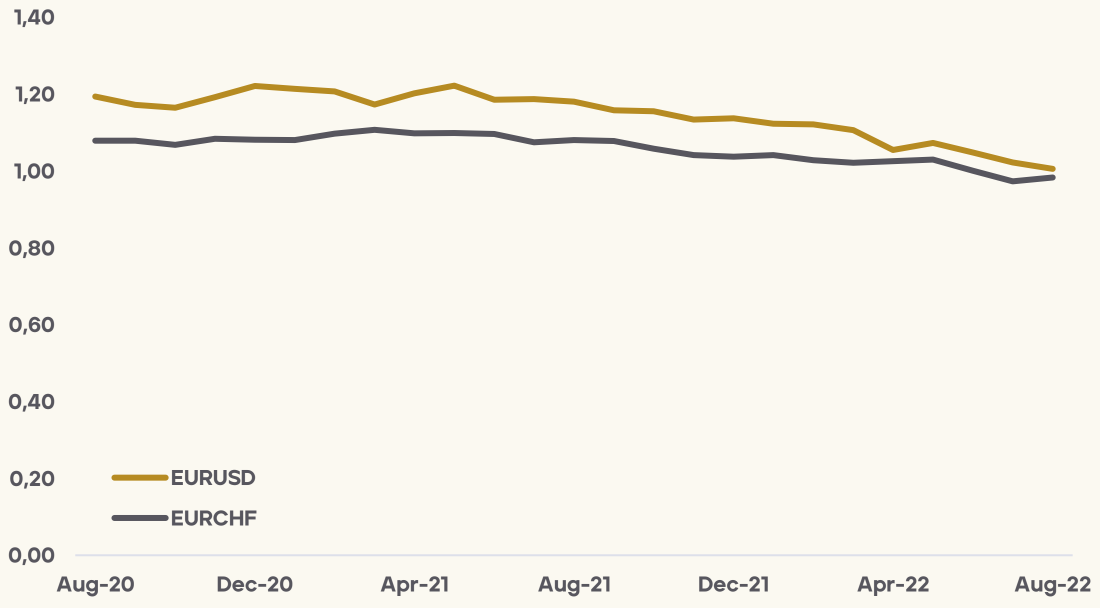
CURRENCIES

The USD resumed its upward trend in August with the Bloomberg Dollar Spot Index reaching new highs, as the Fed aggressively fights inflation and global growth inexorably slows down.

Whilst EUR below parity already prices in a lot of bad news, the curtailment of gas flows and risks of a deeper and longer European contraction means the trigger for a decisive rebound is uncertain, and likely not in place in the short-term.

The JPY is now at over three decades lows against the USD as monetary policy divergence and rising energy prices take their toll on the Japanese currency. Those factors should now fade. A Fed pivot and global economic slowdown could eventually lead to a repricing higher of the JPY.

USD & CHF
EVOLUTION OVER 2 YEARS AGAINST THE EUR



Source: Bloomberg, 31/08/2022

COMMODITIES

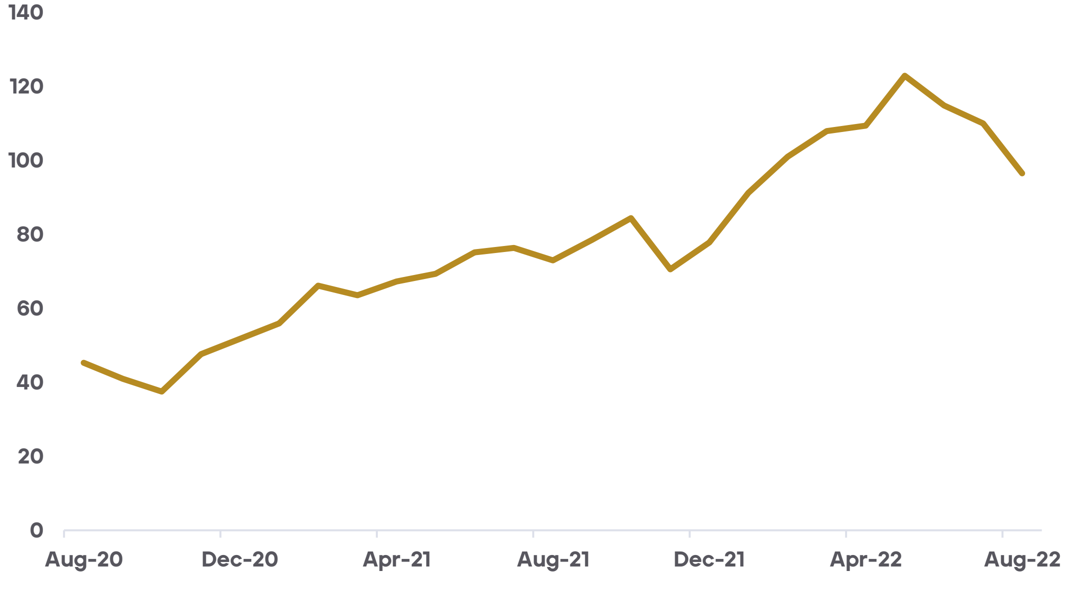
OIL

Oil remained volatile and under downward pressure in August as the positive impact on prices from limited production competes with the negative impact from slower GDP growth and demand. The medium-term outlook remains bearish.

Whilst European gas prices have declined from their August highs thanks to above-average storage builds, the announcement on Sept. 2nd that an oil leak would lead Gazprom's pipeline to stay shut is generating renewed upward pressure on prices. Gas supply uncertainty will keep threatening European growth while governments are racing to avoid a winter energy catastrophe.

Competing forces

OIL
EVOLUTION OF BRENT PRICES OVER 2 YEARS



Source: Bloomberg, 31/08/2022

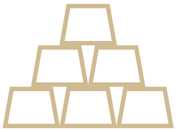
COMMODITIES

GOLD

Gold fell in August amid dollar strength, higher real rates and a hawkish Fed's tone.

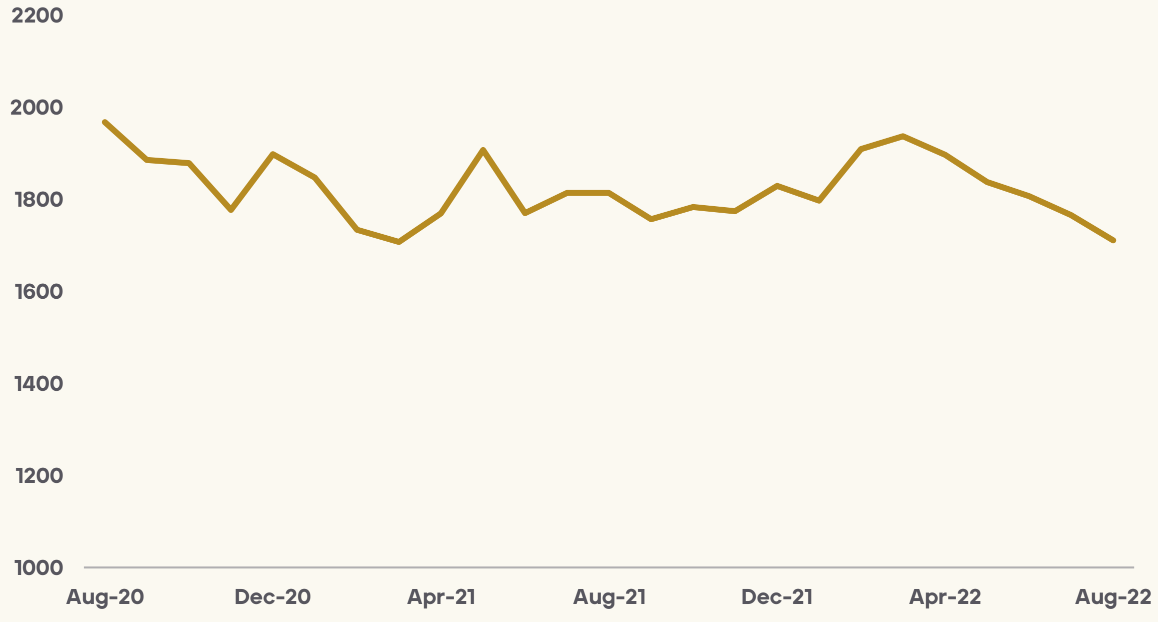
Whilst those factors will likely continue to play out in the near term, they are unlikely to intensify much from here, leaving Gold's downside fairly limited at this stage.

On the other hand, lower real rates would increase the relative benefit of owning Gold and would be a positive signal to increase exposure to the yellow metal.



Range bound

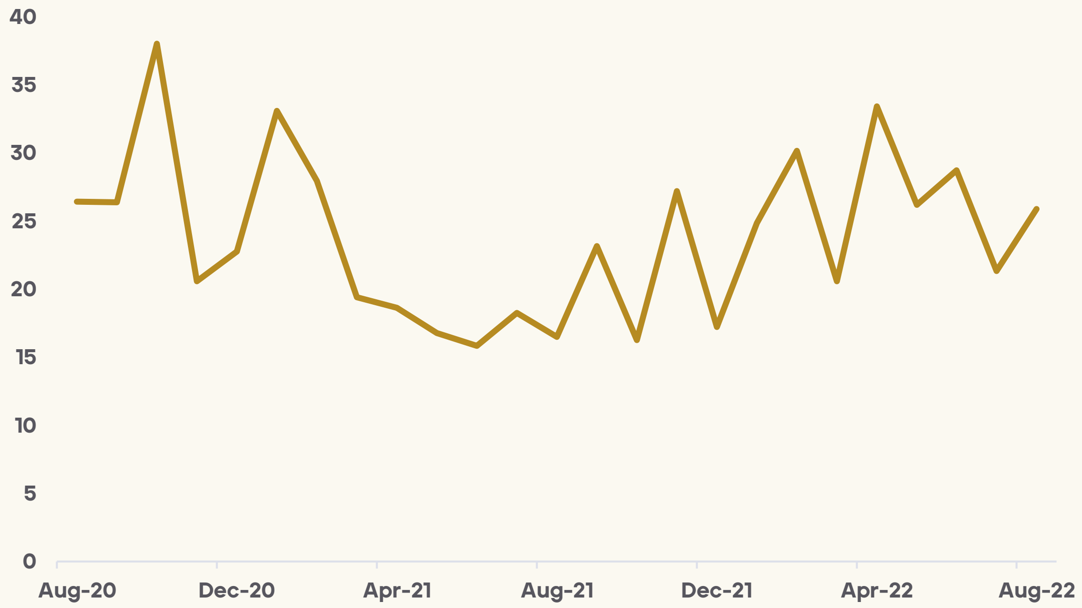
GOLD
EVOLUTION OVER 2 YEARS



Source: Bloomberg, 31/08/2022

VOLATILITY

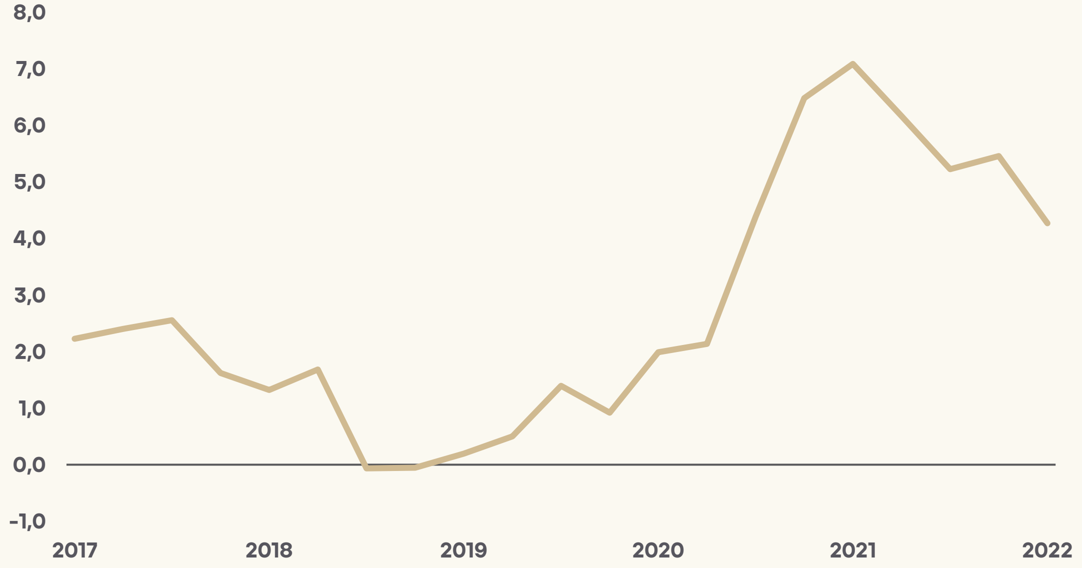
VOLATILITY - VIX INDEX
EVOLUTION OVER 2 YEARS



Source: Bloomberg, 31/08/2022

REAL ESTATE

SWISS RESIDENTIAL REAL ESTATE
ANNUAL PRICE CHANGE



Source: Bloomberg, 31/08/2022

CALENDAR

Date	Country	Economic Data	Period	Previous
02 September	US	Employment (000s)	Sep-22	315,0
	US	Unemployment Rate (%)	Sep-22	3,7
05 September	Eurozone	Markit Services PMI	Sep-22	50,2
	UK	Markit Services PMI	Sep-22	52,5
	Switzerland	Real GDP (QoQ)	Jun-22	0,5
06 September	US	ISM Non-Manufacturing Index	Aug-22	56,7
07 September	China	Exports (YoY)	Aug-22	18,0
	Eurozone	Employment (QoQ)	Sep-22	0,3
	Eurozone	Real GDP (QoQ)	Sep-22	0,6
	Germany	Industrial Production (MoM)	Jul-22	0,4
08 September	Eurozone	ECB Interest Rate (%)	Aug-22	0,0
	Japan	Real GDP (QoQ)	Sep-22	2,2
	Switzerland	Unemployment Rate (%)	Aug-22	2,2
09 September	China	Inflation (YoY)	Aug-22	2,7
13 September	US	Inflation (YoY)	Aug-22	8,5
	UK	Unemployment Rate (%)	Jul-22	3,8
14 September	Eurozone	Industrial Production (MoM)	Jul-22	0,7
	UK	Inflation (YoY)	Aug-22	10,1
	Japan	Industrial Production (MoM)	Aug-22	1,0
15 September	US	Industrial Production (MoM)	Aug-22	0,6
	US	Philadelphia Fed Business Survey	Sep-22	6,2
	UK	Bank of England Interest Rate (%)	Oct-22	1,8
16 September	US	Consumer Confidence	Sep-22	58,2
	China	Retail Sales (YoY)	Aug-22	2,7
16 September	China	Industrial production (YoY)	Aug-22	3,5
21 September	US	Federal Reserve Interest Rate (%)	Aug-22	2,5
22 September	Japan	Bank of Japan Interest Rate (%)	Aug-22	-0,1
	Switzerland	Swiss National Bank Interest Rate (%	Jul-22	-0,3
23 September	Eurozone	Markit Manufacturing PMI	Sep-22	49,6
	UK	Markit Manufacturing PMI	Sep-22	47,3
26 September	Germany	Ifo Business Climate	Sep-22	88,5
	Japan	Nikkei Manufacturing PMI	Sep-22	51,5
29 September	US	Real GDP (QoQ)	Sep-22	-0,6
30 September	China	Caixin Manufacturing PMI	Sep-22	49,5
	Eurozone	Inflation (YoY)	Sep-22	9,1
	Eurozone	Unemployment Rate (%)	Aug-22	6,6
	UK	Real GDP (QoQ)	Sep-22	-0,1
	Switzerland	KOF Leading Indicator	Sep-22	86,5

LET'S TALK ABOUT IT.

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DISCLAIMER