Investment letter

Monthly review of global financial markets

SWISS CAPITAL IB

NOVEMBER 2022

MACROECONOMICS

As another volatile month draws to an end, the only certainty we have seems to be that the transition from 2022 to 2023 looks set to be a period of still uncomfortably high inflation, restrictive central banks and slowing economic data.

September US inflation proved extremely strong again, surprising on the upside at both the headline (8.2%) and core (6.6%) levels. Whilst the former seems to have peaked and is coming down, the latter remains a source of worry, with its strength largely driven by shelter, the most lagging and sticky component of the CPI basket. With 30-year mortgage rates at a 20-year high of over 7%, and the National Association of Homebuilder (NAHB) Index in recession territory, shelter prices will eventually soften. However, lags can be long and variable, generally around one year, making the shelter price index's persistence a key risk to the 2023 disinflationary process Yet, with breakeven inflation rates ranging from 2.5% to 3% at all maturities, and inflation leading indicators having rolled over, the most likely scenario remains for inflation to gradually come down in 2023, while recessionary forces take over.

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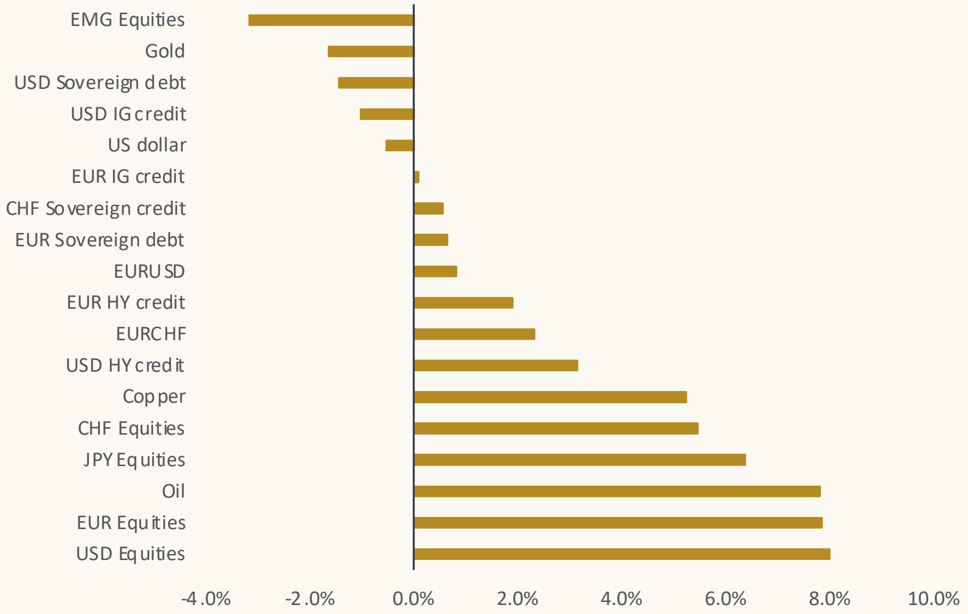
In this context, the US Federal Reserve should keep raising its key interest rates for the next two or three meetings (until February 2023) and stop around 5%. The key uncertainty in our view rests around the timing of the first rate cut, which we would expect towards end-2023, given the harm such a high cost of capital will do to the economy. However, should the labour market surprise on the upside for longer, the Fed may find itself in a difficult position, whereby financial and liquidity stress grow, while realised economic data – which have become her guide in this cycle instead of forward-looking models – have not deteriorated enough to justify a cut.

Meanwhile, the Eurozone is all but certain to enter a recession in the months to come – if it is not already done. October flash PMIs (economic leading indicators) all came out well in contractionary territory for a fourth month in a row while consumer confidence is at its lowest level ever amid the deepest cost-of-living crisis since the creation of the Eurozone.

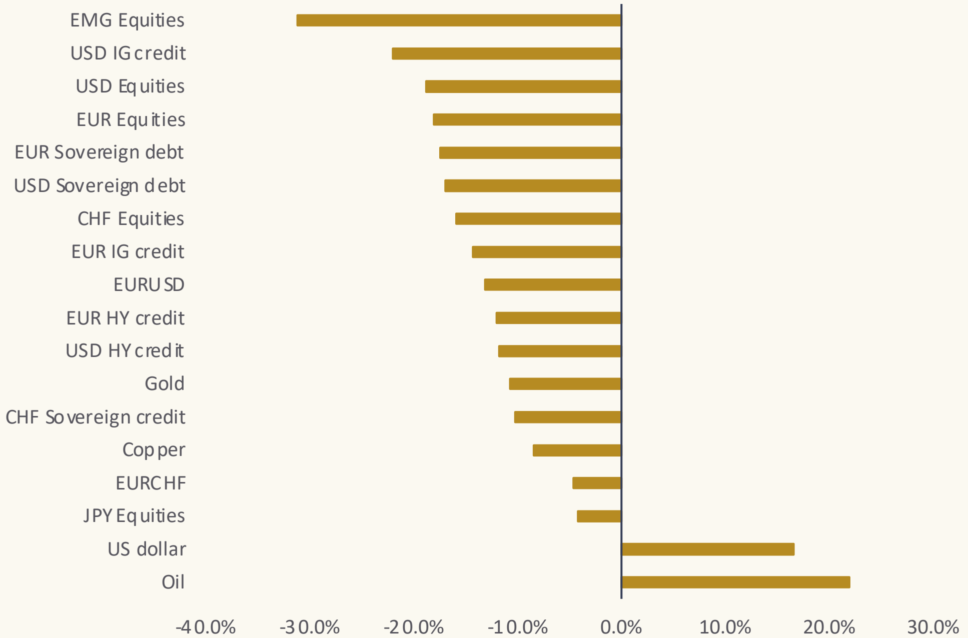
OVERVIEW

MAIN ASSET CLASSES
MONTHLY PERFORMANCE



Source: Bloomberg, from 30/09/2022 to 31/10/2022

MAIN ASSET CLASSES
PERFORMANCE YEAR-TO-DATE



Source: Bloomberg, 31/10/2022

MACROECONOMICS (continued)

With headline inflation in the 10% area, the European Central Bank's job remains extremely complex. It has chosen the route of aggressive rate hikes for now, but we believe systemic stress and economic pain will force the Bank to pause its hiking cycle much earlier than markets expect, likely in the 2%-2.5% range for the key deposit rate, despite inflation still well above target. As the Bank of England's reaction to the ramifications of UK Truss's proposed budget reminded us, the mandate of a central bank is not only inflation, but also financial stability. The latter will soon become a matter of importance in the Eurozone.

In this context, we continue to advocate a prudent allocation. Recession means that we should avoid balance sheet risks in all asset classes, and we like quality within both fixed income and equity. Whilst we believe an underweight equity is still warranted, an end-of-the year bear market rally is possible. Moreover, timing the trough in economic data and central banks' first-rate cuts is difficult. Hence the need to remain exposed. On the other hand, we keep an overweight fixed income, where rates provide a good entry point, especially if we believe that central banks' hawkishness has reached a peak. And indeed, central banks will likely not do much more than what has already been communicated. Thus, a lot is already in bonds' pricing.

EQUITY MARKETS

Equity indices vulnerable to short term rally, but too early to turn structurally bullish

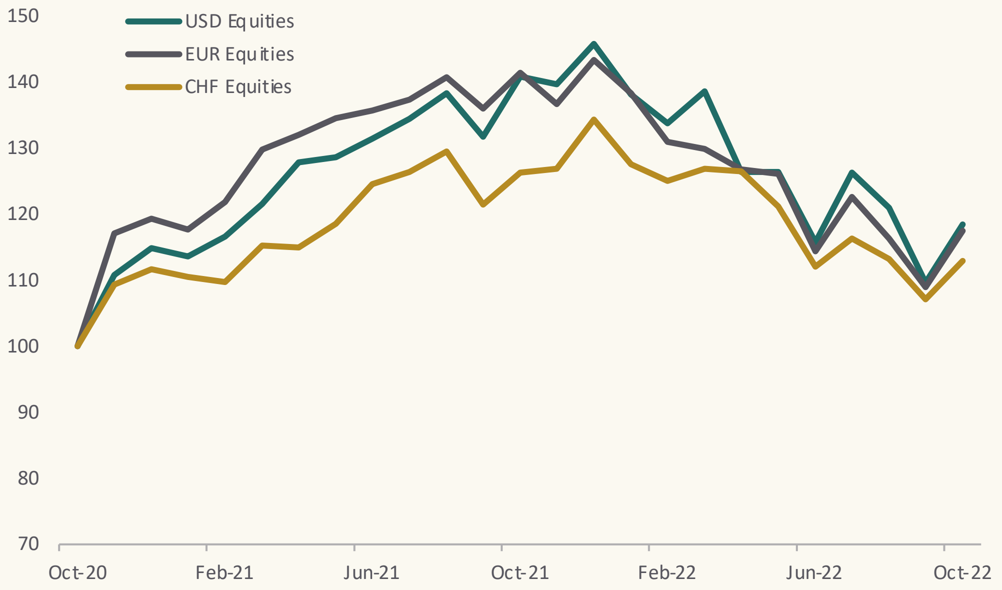
Results of the third quarter equity earnings season so far are coming in ahead of "low expectations", with Cyclicals leading Defensives significantly on Earnings-Per-Share beats. Given an historically strong Underweight positioning, we believe a bear market rally into year-end is in the cards.

That said, we think it is still too early to change our view fundamentally and remain strategically bearish. A trough in economic data and more visibility on central banks' first-rate cuts will be needed for equity markets to enter a sustainable rally.

We therefore reiterate our strong conviction that Quality baskets and Low vol strategies are the best way to navigate this volatile and uncertain environment, while some cyclicals already pricing a recession might see a mean reversion trade to the upside.

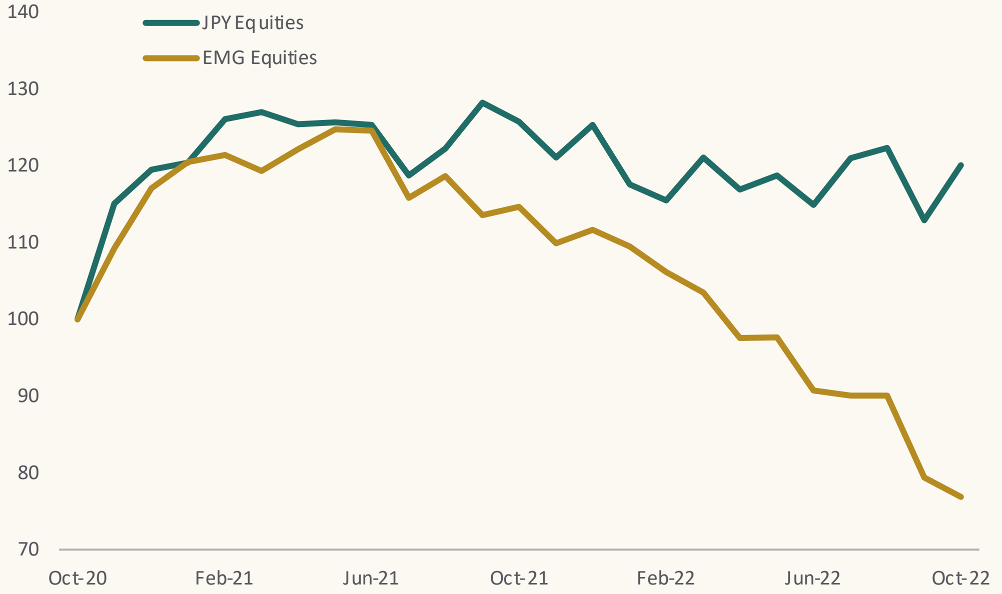
EQUITY MARKETS

EQUITY MARKETS EUR USD CHF
PERFORMANCE OVER 2 YEARS



Source: Bloomberg, 31/10/2022

EQUITY MARKETS JAPAN – EMERGING MARKETS
PERFORMANCE OVER 2 YEARS



Source: Bloomberg, 31/10/2022

BOND MARKETS

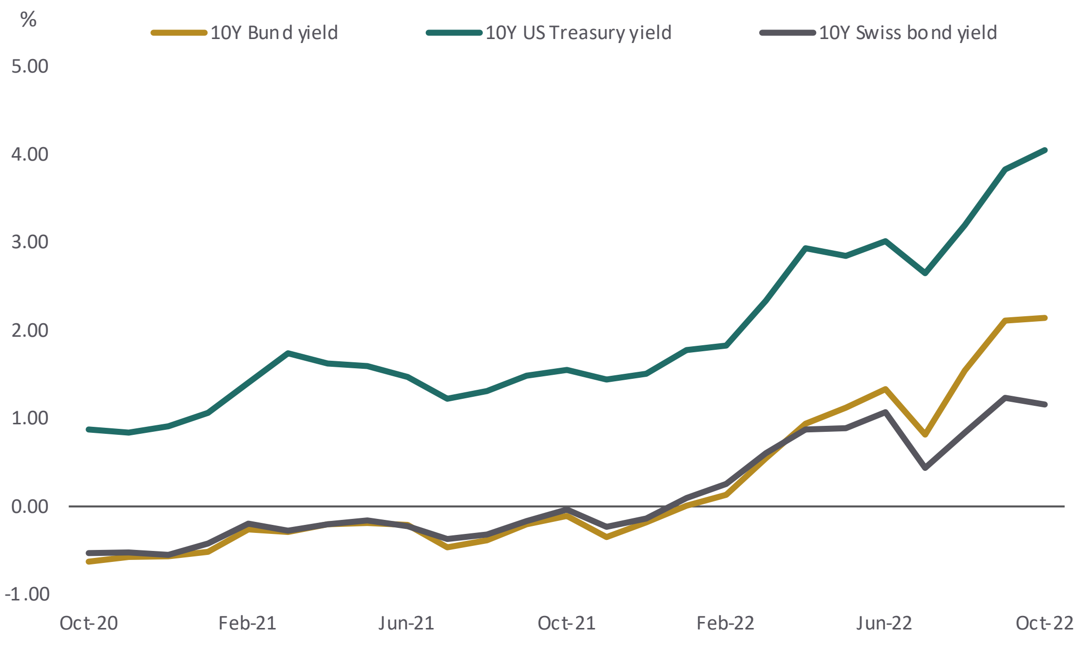
With markets now pricing terminal rates in extremely restrictive territory, we expect more focus on the lagged effect of rate hikes on economic performance. Falling inflation and slower growth ahead will act as a powerful catalyst for extremely cheap and oversold government bonds. We maintain an overweight US treasuries, Core European Government Bonds and Supra Sovereigns.

Corporate credit is extremely cheap, especially for higher quality segments. Global liquidity conditions remain challenging, but we believe the recent underperformance of AT1s, exacerbated by Credit Suisse uneasiness, created a very attractive entry point in the financial space with EUR AT1-BB spreads approaching a 10-year record. Indeed, financial institutions are in robust shape with lower earnings risk. As default rates rise materially in a recessionary context next year, we believe the more defensive parts of the capital structure (senior and T2) in all major currencies offer good opportunities. We overweight non-cyclical Investment Grade/BB bonds and financial credit.

Rapid Fed tightening, rise in US yields and USD strength all contributed to EM's poor relative performance, but we expect better performance ahead as central banks turn less hawkish. We upgrade EM debt to neutral.

"We have a strong preference for financial credit beta"

10Y SOVEREIGN BOND YIELDS
EVOLUTION OVER 2 YEARS



Source: Bloomberg, 31/10/2022

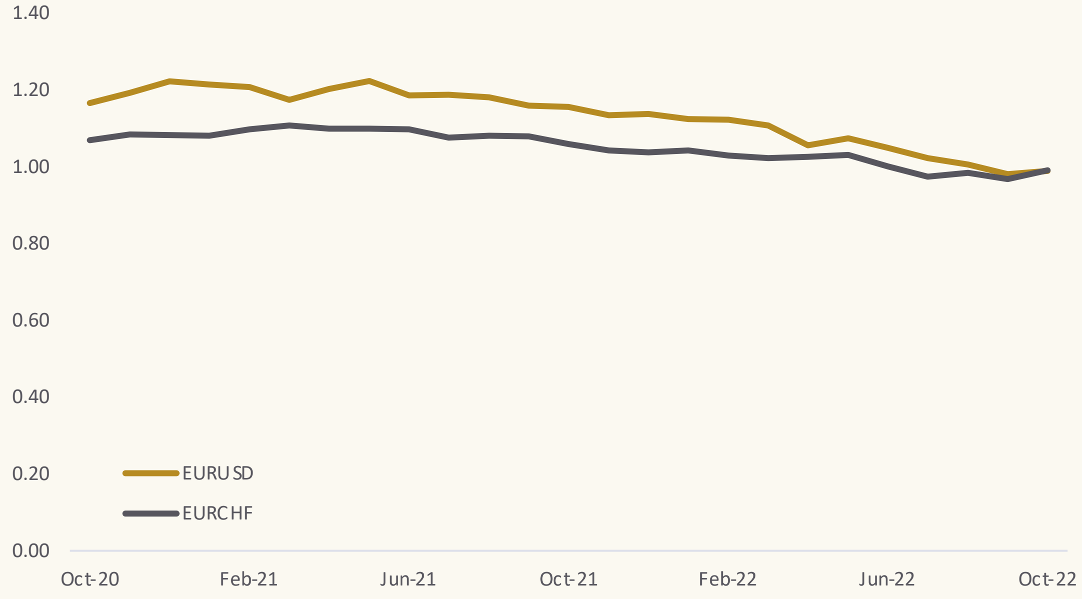
CURRENCIES

Despite a relative stabilization of the USD in October, it is too early to expect a decisive reversal. As long as monetary policies remain easy in Japan and China, and the energy crisis live in Europe, the USD will be the safest place to hide, with high carry. A sustainable USD reversal would need both a Fed pivot and a better trajectory for global growth. Indeed, Fed cuts alone might not be sufficient, as the USD tends to rally when the global economy is in recession.

Although risks remain skewed to the downside in the near-term, EUR below parity is already pricing in a lot of bad news. Longer-term, the EUR may come back up to a lower fair value than pre-Covid, which we would estimate around 1.10.

Finally, the JPY story is intimately linked to monetary policy's divergence with the US. 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, 31/10/2022

COMMODITIES

OIL

Oil was supported in October by OPEC+ pro-active stance, combined with the progressive loss of Russian supplies. Moreover, geopolitical risk premia could rise further, especially if high inflation and food insecurity threaten political stability in important oil-producing countries, particularly in the Middle-East.

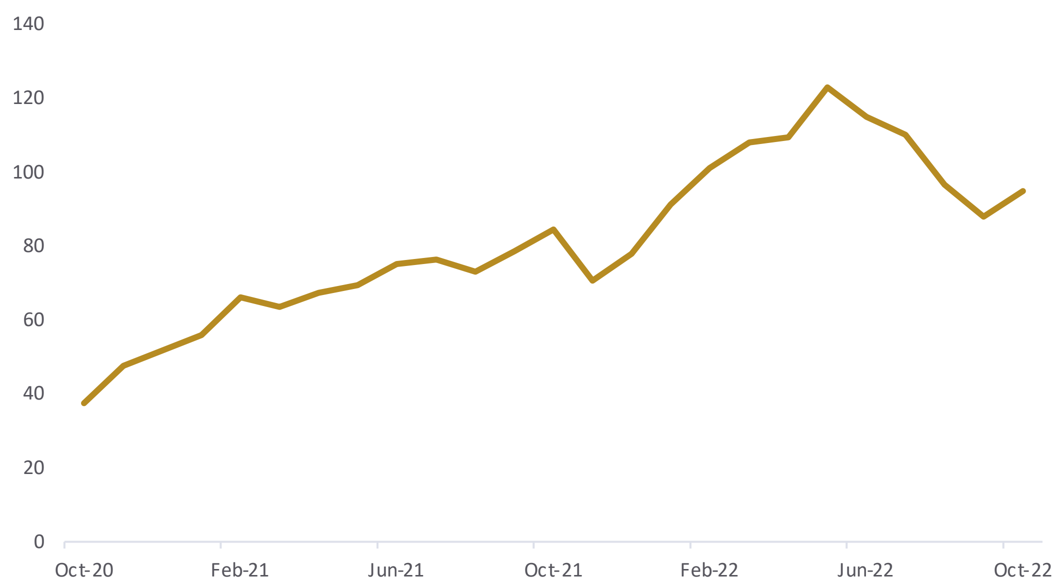
That said, a looming global recession will weigh on oil consumption, notwithstanding Chinese zero Covid policy.

As such, there may be a floor under prices in the near-term, and oil remains an interesting geopolitical hedge, but downward pressures are likely to dominate in 2023.

Slowdown prevails

OIL

EVOLUTION OF BRENT PRICES OVER 2 YEARS

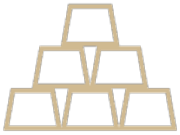


Source: Bloomberg, 31/10/2022

COMMODITIES

GOLD

With real rates at a over 10-year highs, Gold remains mostly under downward pressure, and ~20% down from its peak in the wake of the Russian invasion of Ukraine.

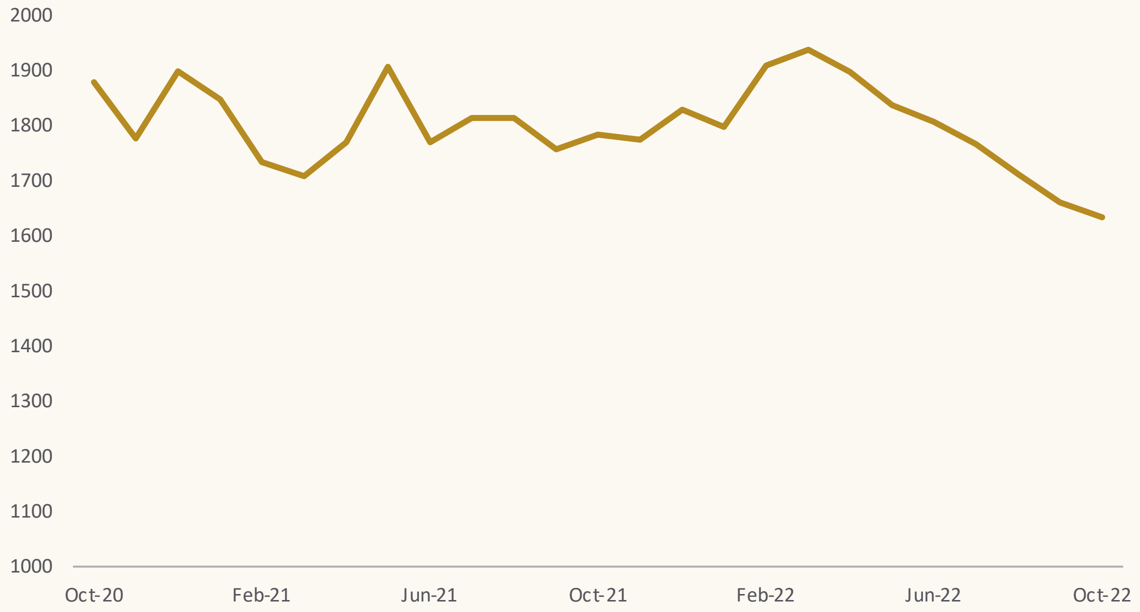


No shine when real rates rise

In the near-term, peak hawkishness in central banks' approach to monetary policies may lead to some stabilisation of real rates at high level (US real rates ~1.6% from 2 to 10yr).

Going forward, a more decisive downtrend in real rates will be needed to increase the relative benefit of owning Gold.

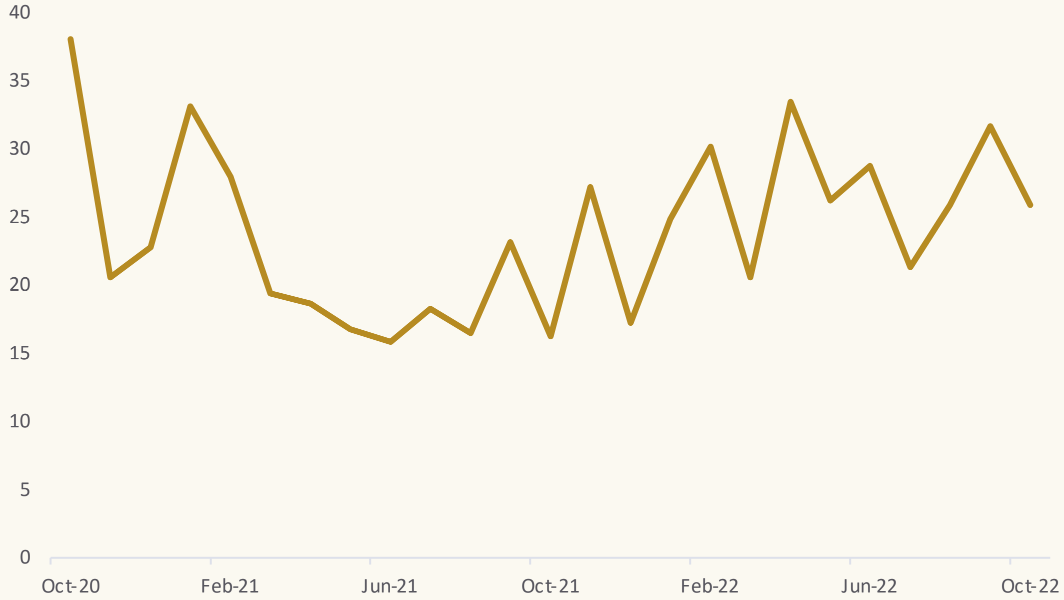
GOLD
EVOLUTION OVER 2 YEARS



Source: Bloomberg, 31/10/2022

VOLATILITY

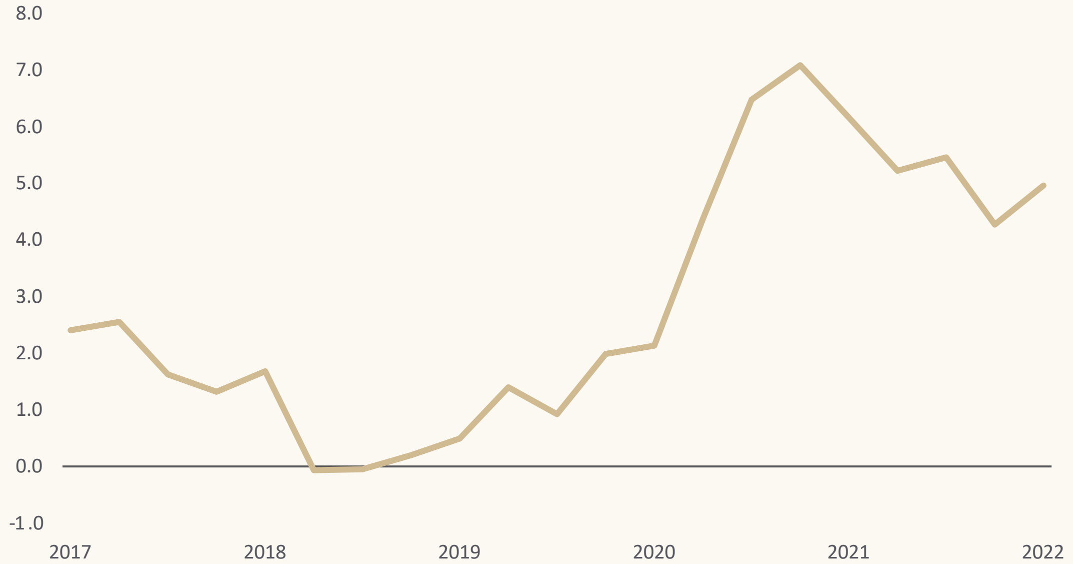
VOLATILITY – VIX INDEX
EVOLUTION OVER 2 YEARS



Source: Bloomberg, 31/10/2022

REAL ESTATE

SWISS RESIDENTIAL REAL ESTATE
ANNUAL PRICE CHANGE



Source: Bloomberg, 31/10/2022

CALENDAR

Date	Country	Economic Data	Period	Previous
02 November	US	Federal Reserve Interest Rate (%)	Oct-22	3,3
	Eurozone	Markit Manufacturing PMI	Nov-22	46,4
03 November	US	ISM Non-Manufacturing Index	Oct-22	56,7
	Eurozone	Unemployment Rate (%)	Sep-22	6,6
	UK	Markit Services PMI	Nov-22	47,5
	UK	Bank of England Interest Rate (%)	Dec-22	2,3
	Switzerland	Inflation (YoY)	Oct-22	3,3
04 November	US	Employment (000s)	Oct-22	263,0
	US	Unemployment Rate (%)	Oct-22	3,5
	Eurozone	Markit Services PMI	Nov-22	48,2
07 November	China	Exports (YoY)	Oct-22	5,7
	Germany	Industrial Production (MoM)	Sep-22	-0,8
	Switzerland	Unemployment Rate (%)	Oct-22	2,1
09 November	China	Inflation (YoY)	Oct-22	2,8
10 November	US	Inflation (YoY)	Oct-22	8,2
11 November	US	Consumer Confidence	Nov-22	59,9
	UK	Real GDP (QoQ)	Sep-22	0,2
14 November	Eurozone	Industrial Production (MoM)	Sep-22	1,5
15 November	China	Retail Sales (YoY)	Oct-22	2,5
	China	Industrial production (YoY)	Oct-22	3,9
	Eurozone	Employment (QoQ)	Sep-22	0,4
	Eurozone	Real GDP (QoQ)	Dec-22	0,2
	France	Unemployment Rate (%)	Sep-22	7,4
	UK	Unemployment Rate (%)	Sep-22	3,5
	Japan	Industrial Production (MoM)	Oct-22	-1,6
	Japan	Real GDP (QoQ)	Sep-22	3,5
16 November	US	Industrial Production (MoM)	Oct-22	0,4
	UK	Inflation (YoY)	Oct-22	10,1
17 November	US	Philadelphia Fed Business Survey	Nov-22	-8,7
23 November	US	Fed minutes	Mar-24	
	UK	Markit Manufacturing PMI	Nov-22	46,2
24 November	Germany	Ifo Business Climate	Nov-22	84,3
	Japan	Nikkei Manufacturing PMI	Nov-22	50,7
25 November	Germany	Real GDP (QoQ)	Dec-22	0,3
29 November	Switzerland	Real GDP (QoQ)	Sep-22	0,3
30 November	US	Real GDP (QoQ)	Dec-22	2,6
	Eurozone	Inflation (YoY)	Nov-22	10,7
	France	Real GDP (QoQ)	Dec-22	0,2
	Italy	Real GDP (QoQ)	Dec-22	0,5
	Switzerland	KOF Leading Indicator	Nov-22	90,9

LET'S TALK ABOUT IT.

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