Investment letter

Monthly review of global financial markets

SWISS CAPITAL IB

JANUARY 2023

MACROECONOMICS

December data showed that the US economy has indeed been resilient until now, with third quarter annualised GDP growth revised up to a healthy 3.2%, a still tight labour market and an expanding November ISM Services index.

That said, signs of slowdown and disinflation are equally clear. The November ISM manufacturing index fell below 50 (to its lowest since Dec. 2019) while December PMIs were unambiguously contractionary in both manufacturing and services sectors. Similarly, the December NAHB (housing) index continued to collapse for a 12th straight month, signalling housing recession and much slower growth in the US this year. Meanwhile, US November inflation confirmed the October downtrend, with YoY Headline CPI down to 7.1% from 7.7%, and Core CPI to 6.0% from 6.3%. Stripping out the Shelter component, undoubtedly the most lagging – and poised for normalisation in the next 12 months if the NAHB index proves as reliable as in the past – the monthly growth in CPI was actually negative.

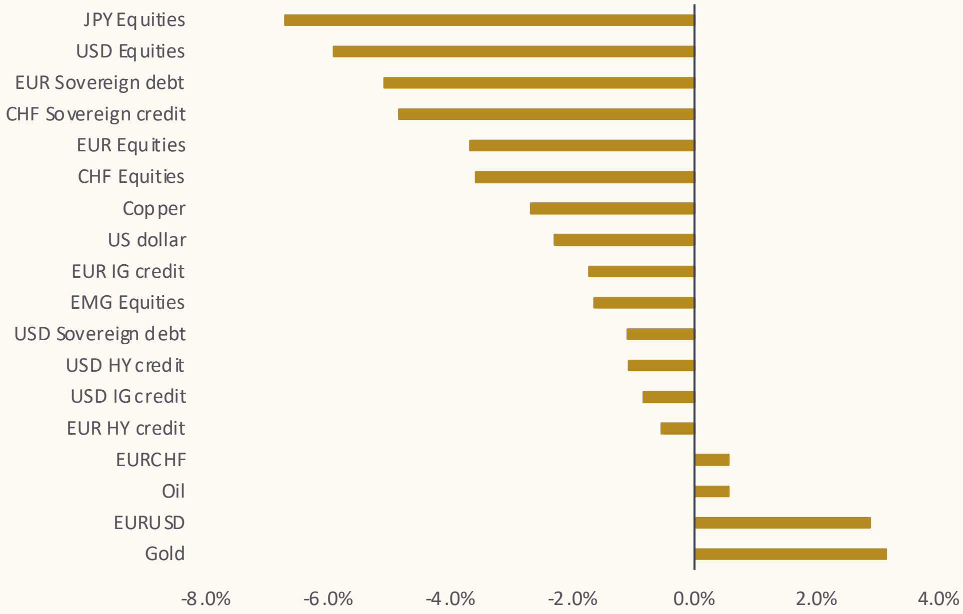
"As we enter 2023, uncertainty has shifted from the end of the tightening cycle to the starting date and amplitude of the easing cycle"

In this context, the Fed raised its policy rates by 50bps as expected, to 4.25%-4.5%, and upgraded its 4.6% September expectation for the terminal rate to 5.1%, just slightly above markets' expectations, implicitly acknowledging that slowdown and disinflation call for an end to the tightening cycle in the next few months. Thereafter, FOMC members don't expect cuts in 2023, in contrast to future markets that have ~50bps of rate cuts embedded in H2 2023. This disconnect persists in 2024, with the Fed expecting only ~50bps worth of cuts over the course of the year, while markets see rates ~160bps below their peak at the end of 2024.

As such, as we enter 2023, uncertainty has shifted from the end of the tightening cycle, which seems now relatively well telegraphed, to the starting date and amplitude of the easing cycle. We believe the timing of the first rate cut will be highly data-dependent and could indeed happen only early 2024. But when the Fed starts cutting rates, it will very likely be much quicker than expected. A cutting cycle is rarely gradual.

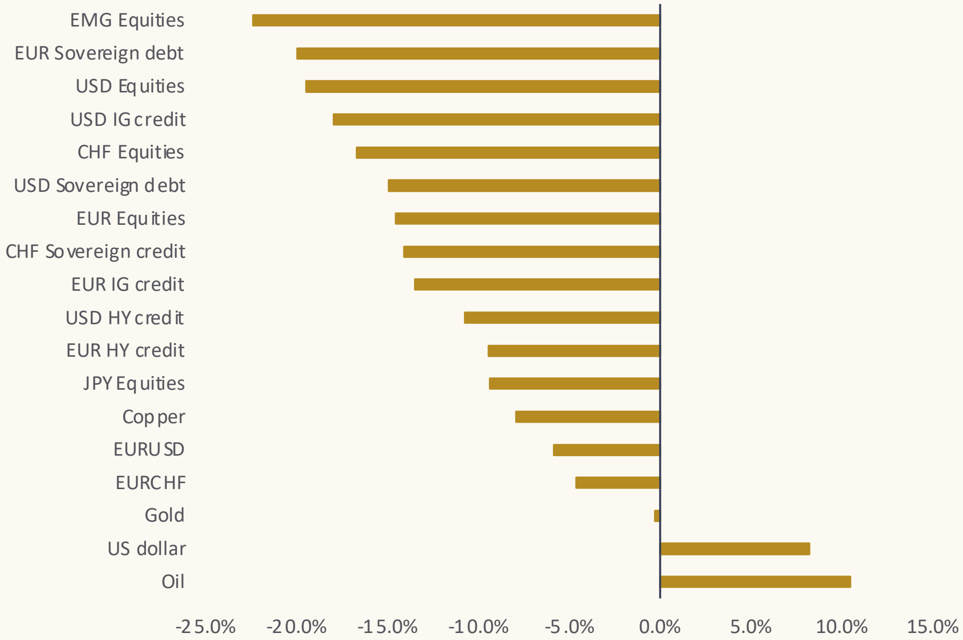
OVERVIEW

MAIN ASSET CLASSES
MONTHLY PERFORMANCE



Source: Bloomberg, from 30/11/2022 to 30/12/2022

MAIN ASSET CLASSES
PERFORMANCE YEAR-TO-DATE



Source: Bloomberg, 30/12/2022
Past performance is not indicative of future performance

MACROECONOMICS (continued)

Meanwhile, European economic activity showed timid green shoots with improving consumer confidence and PMIs up, likely reflecting the fact that worst case scenarios are not materialising at this stage. However, data remain highly depressed with recession the most likely scenario in the next quarters.

This did not prevent the ECB to adopt a disruptively hawkish tone and forward guidance. While raising the three key interest rates by 50bps (depo rate at 2%) was expected, the rest was more surprising to markets.

Christine Lagarde took the complete opposite stance from the October meeting, where growth seemed a worry, and pre-announced multiple 50bps rates increases from here, while also predicting a short and shallow recession, as well as higher inflation than in her previous forecasts. As a result, financial stress concerns will likely come back to fore, with possibly a deeper than necessary recession to bring down still mostly supply-driven inflation.

Finally, the way Chinese re-opening will pan out remains an open question. The overall trend is positive for global trade, global growth and European exporters, but near-term bumps cannot be ruled out. Indeed, China's Covid hospitalisation and death rates have yet to peak, and domestic mobility remains subdued. Much will depend on the recovery of Chinese consumers' confidence, which could turn out to be very gradual.

EQUITY MARKETS

Global equity market performance was mixed in December, with US and European stocks declining (S&P 500: -6%; Stoxx 600: -3%), the CSI 300 index in China little changed, while Hong Kong equities advanced (Hang Seng: +6%), helped by reopening optimism. Contributing to the weakness in US and European equities was a spike in real bond yields (i.e. the discount rate for equities). In US, December 2022 ended as the 3rd worst December for S&P 500 going back to 1950 (1st being 2018, close 2nd being 2002), as the market's optimism following softer CPI prints clashed with a continued hawkish Fed and continued retail supply. While the magnitude of December's decline was impressive on its own, the consistency of daily declines was also noteworthy: S&P 500 had 14 days of negative returns in December (the 2nd highest for any month in 2022) and only 1 day above +1.5% (the least of any month in 2022).

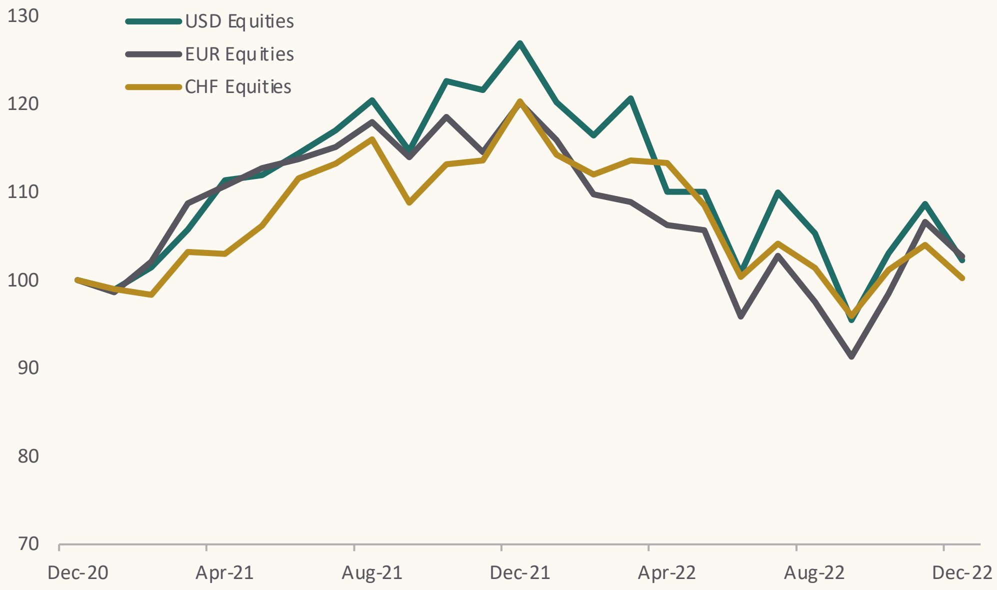
The bull case means that investors could start to re-risk sooner rather than later.

The bearish scenario would be a larger-than-expected decline in earnings combined with net liquidity outflow from the system.

In Europe, the best performing sectors were the rates-sensitive banks and insurance sectors (+4% and +3% relative to the market, respectively), as well as the China-exposed mining sector. The worst performers were semis (-7%), software (-5%) and autos (-3%).

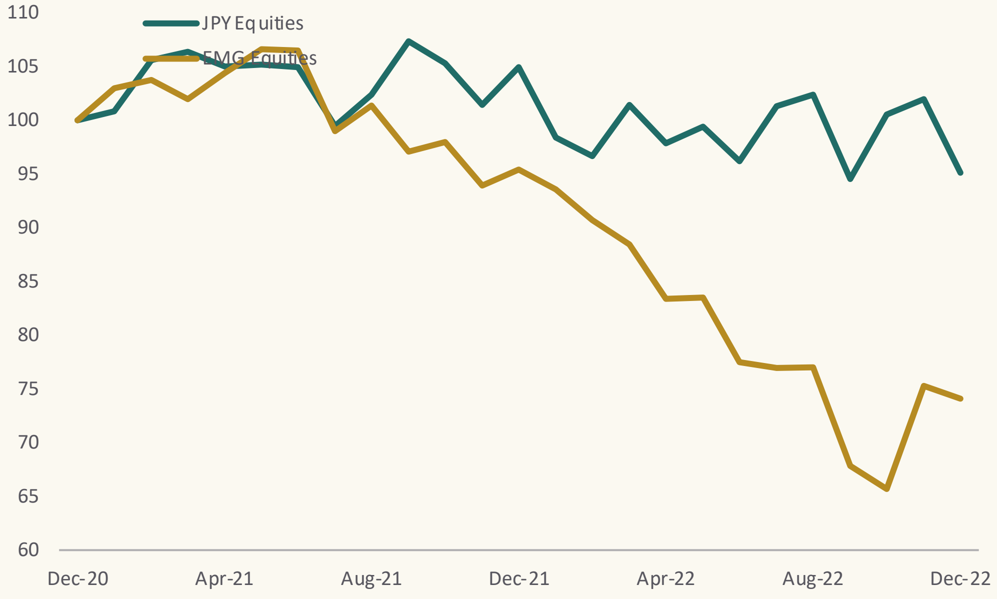
EQUITY MARKETS

EQUITY MARKETS EUR USD CHF
PERFORMANCE OVER 2 YEARS



Source: Bloomberg, 30/12/2022

EQUITY MARKETS JAPAN – EMERGING MARKETS
PERFORMANCE OVER 2 YEARS



Source: Bloomberg, 30/12/2022
Past performance is not indicative of future performance

BOND MARKETS

Following the ECB meeting and the subsequent widening of the JGB yield band by the Bank of Japan (BoJ), **global government bond yield curves bear steepened in the second half of the month**.

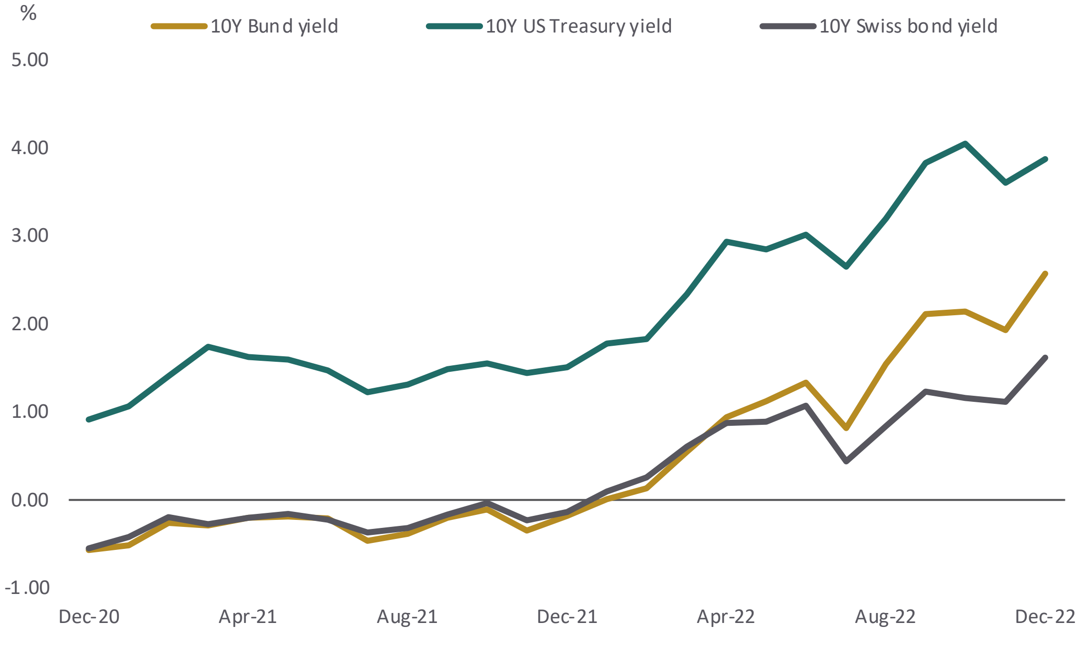
In a surprisingly late twist, **the ECB signalled a much more hawkish stance than expected**. This led European government bonds through their October yield highs. In our opinion, **the ECB is yet again edging towards a late cycle policy mistake** as both inflation and real growth are highly likely to soften materially in coming months.

Despite the late December move in European Government Bond yields, **interest rate implied volatility remained close to recent lows**, helping credit spreads continue their grind tighter.

The late month interest rate retracement led **AT1s to outperform senior and T2 bonds** on a total and excess return basis. More generally, **financial credit outperformed the wider corporate bond market.**

> " Financial credit continues to offer a very compelling risk-return profile "

10Y SOVEREIGN BOND YIELDS
EVOLUTION OVER 2 YEARS



Source: Bloomberg, 30/12/2022
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CURRENCIES

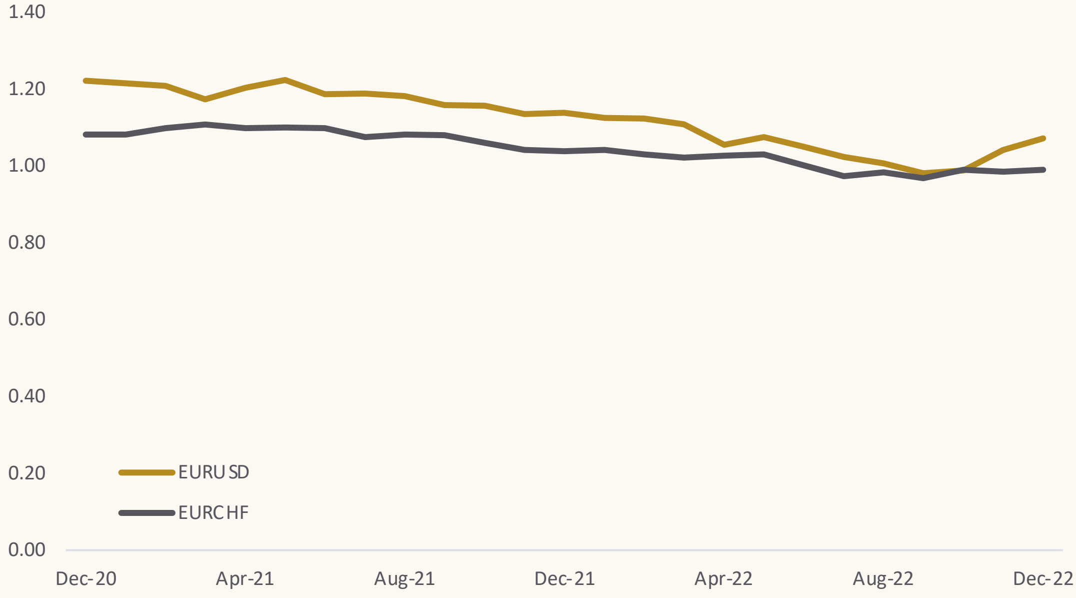
As the Fed confirmed its pre-announced slower pace of rate hikes with a 50bps increase in December, and as the end of the tightening cycle becomes clearer, the USD continued to weaken. The next few months could turn out more range-bound for the greenback as concerns around global growth intensify, but the USD's peak is now likely behind.

We expect EUR-USD to remain fairly range-bound from here as we estimate the fair-value to be around 1.10. While more clarity on the timing of the first rate cut could lift the pair, a deeper-than-expected recession in the Eurozone may play out in the other direction.

We continue to favour EUR versus CHF, as the pair should benefit from monetary policy differential. The ECB is still battling high inflation, while the Swiss National Bank has no reason to hike aggressively given low inflation, and reasons to remain cautious as growth will suffer from a Eurozone recession.

Finally, JPY-USD went through another leg up as the Bank of Japan expanded the range of its 10y JGB yield target to 0.5%. Regardless of future policy decisions, we believe there is more upside to the JPY versus USD as monetary policy differential fades in the months and quarters to come.

USD & CHF
EVOLUTION OVER 2 YEARS AGAINST THE EUR



Source: Bloomberg, 30/12/2022
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COMMODITIES

OIL

Oil remained well below its 2022 peak in December as a looming global economic slowdown weighs on demand.

However, some tightness in energy markets may carry over into 2023 with Russian oil embargoes, low LNG supply growth and OPEC+ potentially continuing to regularly cut output. Moreover, the Chinese reopening may provide some support to the demand profile.

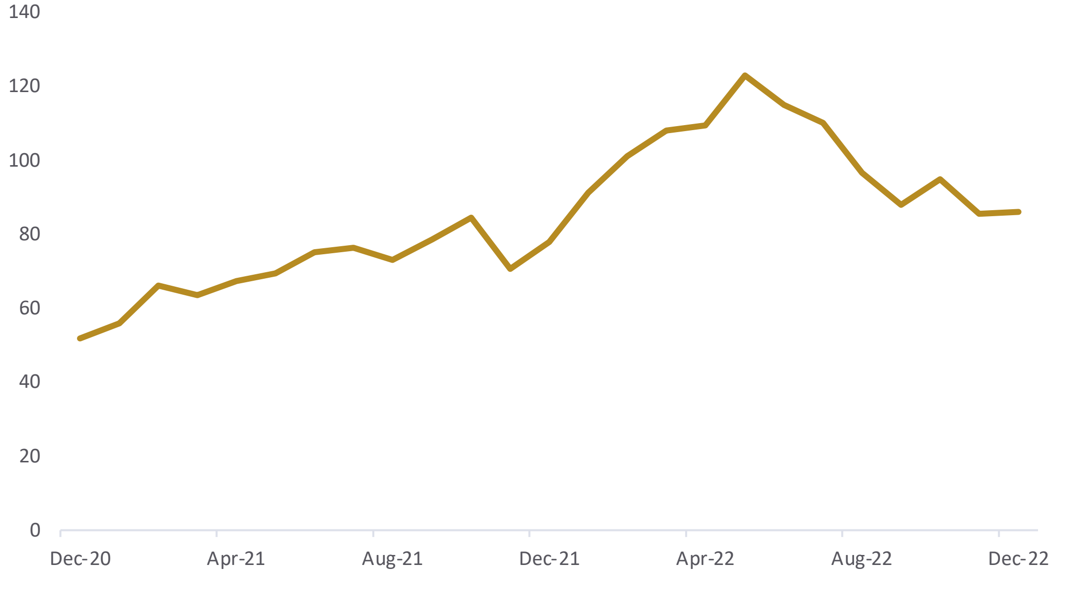
In all, oil prices remain stuck between competing forces of constrained supply and muted demand linked to slower global growth.

In this context, we expect overall downward pressure to persist, but with a floor and still elevated volatility, on oil prices.

Oil prices remain stuck between competing forces of still constrained supply, but more muted demand, in 2023

OIL

EVOLUTION OF BRENT PRICES OVER 2 YEARS



Source: Bloomberg, 30/12/2022

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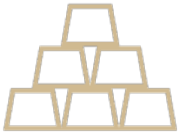
COMMODITIES

GOLD

Gold continued to creep up in December as the Fed confirms a slowdown in its hiking cycle pace, with the terminal rate now in sight.

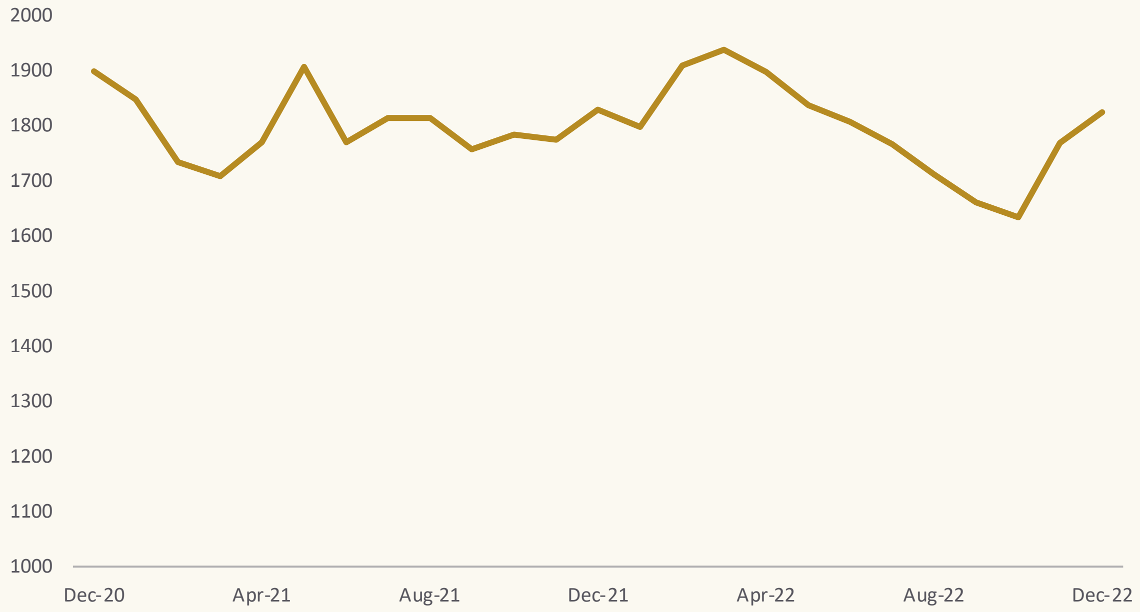
Given still elevated real rates, it might be a little early to significantly increase exposure to Gold.

However, as recessionary forces materialise and real rates start to compress more significantly, the relative benefit of owning Gold will also increase, which might happen sometimes in 2023.



The relative benefit of owning Gold might increase later in 2023 when real rates start to compress

GOLD
EVOLUTION OVER 2 YEARS



Source: Bloomberg, 30/12/2022
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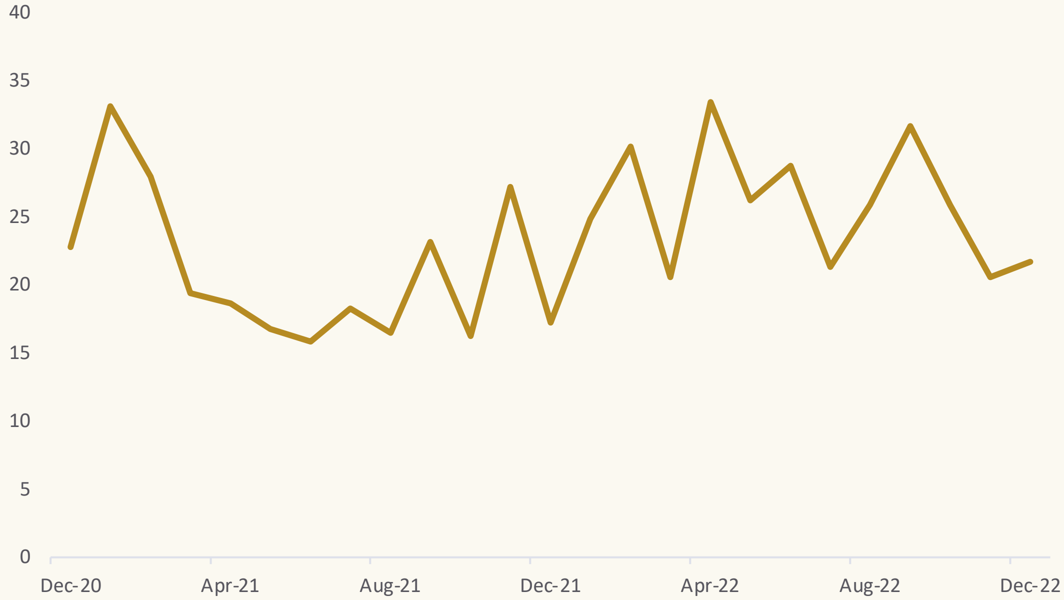
VOLATILITY

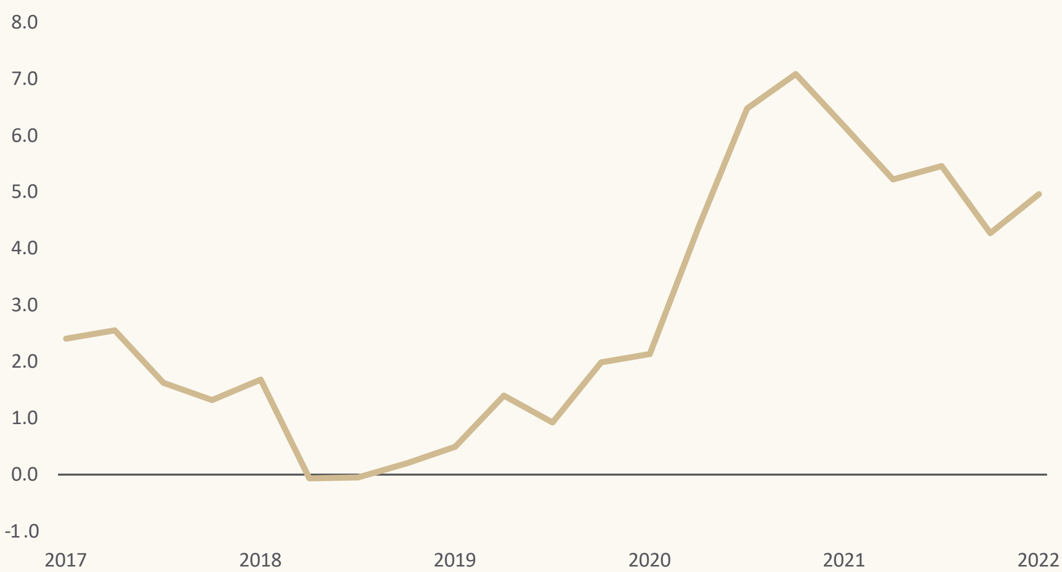
VOLATILITY – VIX INDEX
EVOLUTION OVER 2 YEARS



Source: Bloomberg, 30/12/2022

REAL ESTATE

SWISS RESIDENTIAL REAL ESTATE
ANNUAL PRICE CHANGE



Source: Bloomberg, 30/12/2022
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CALENDAR

Date	Country	Economic Data	Period	Previous
04 January	US	Manufacturing PMI	Jan-23	48,4
	US	Fed minutes	Mar-24	
	Eurozone	Markit Services PMI	Jan-23	49,8
	Switzerland	Inflation (YoY)	Jan-23	2,8
05 January	UK	Markit Services PMI	Jan-23	50,0
06 January	US	Employment (000s)	Dec-22	263,0
	US	Unemployment Rate (%)	Dec-22	3,7
	US	ISM Non-Manufacturing Index	Dec-22	56,5
	Eurozone	Inflation (YoY)	Dec-22	10,0
09 January	China	Inflation (YoY)	Dec-22	1,6
	Eurozone	Unemployment Rate (%)	Nov-22	6,5
	Germany	Industrial Production (MoM)	Nov-22	-0,1
	Switzerland	Unemployment Rate (%)	Dec-22	2,0
10 January	China	Retail Sales (YoY)	Dec-22	-5,9
	China	Industrial production (YoY)	Dec-22	3,8
12 January	US	Inflation (YoY)	Dec-22	7,1
13 January	US	Consumer Confidence	Jan-23	59,7
	China	Exports (YoY)	Dec-22	-8,9
	China	Real GDP (YoY)	Dec-22	3,9
	Eurozone	Industrial Production (MoM)	Nov-22	-2,0
17 January	UK	Unemployment Rate (%)	Nov-22	3,7
18 January	US	Industrial Production (MoM)	Dec-22	-0,2
	UK	Inflation (YoY)	Dec-22	10,7
	Japan	Industrial Production (MoM)	Dec-22	-0,1
18 January	Japan	Bank of Japan Interest Rate (%)	Jan-23	-0,1
19 January	US	Philadelphia Fed Business Survey	Jan-23	-13,8
24 January	Eurozone	Markit Manufacturing PMI	Jan-23	47,8
	UK	Markit Manufacturing PMI	Jan-23	45,3
	Japan	Nikkei Manufacturing PMI	Jan-23	48,9
25 January	Germany	Ifo Business Climate	Jan-23	88,6
26 January	US	Real GDP (QoQ)	Dec-22	3,2
31 January	Eurozone	Real GDP (QoQ)	Dec-22	0,3
	France	Real GDP (QoQ)	Dec-22	0,2
	Germany	Real GDP (QoQ)	Dec-22	0,4
	Italy	Real GDP (QoQ)	Dec-22	0,5
	Switzerland	KOF Leading Indicator	Jan-23	92,2

LET'S TALK ABOUT IT.

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DISCLAIMER