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Investment Policy

Q3 2022 | June 2022

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Key points

Regime change in progress

Inflation is back at levels not seen for 40 years, radically reshaping the **financial landscape** that has been in place since the great financial crisis of 2008.

After battling long and hard against the risk of deflation with ultra-accommodative monetary policies, central banks have initiated a U-turn and embarked on a cycle of **monetary tightening** to limit the risk of an inflationary spiral. Interest rates are rising significantly. On long-dated bonds (ten years), sovereign yields have risen more than 180 bps in the US and the eurozone and more than 170 bps in Switzerland. This spike has fed through into historically very negative returns (-15% in USD and EUR and -11% in CHF), pretty similar to the return on equities, even though shares are much riskier.

While sovereign and corporate bonds alike are suffering as interest rates climb, the decline in equities can be wholly blamed on the squeeze on valuations, with corporate earnings growth expectations not yet affected (**Chart 1**). This pattern is the logical upshot of an **across-the-board rerating of risk**: as risk-free assets get cheaper (i.e. as sovereign bonds offer higher yields), this has a cascade effect, triggering downward adjustments in valuations of other assets.

The **good news** is that, for the first time in years, we can invest in short-duration investment-grade (i.e. defensive) corporate bonds offering acceptable yields.

More generally, while moving from a zero-interest-rate environment with plentiful liquidity to a **regime** of interest rates offering more lucrative returns and liquidity in shorter supply is a painful process for the performance of most assets, it is the price that must be paid if we are to return to a more normal financial world.

Scenario and conclusions

- Combating **inflation** is now the priority for authorities
- Central banks have embarked on monetary **tightening**
- The risk of **recession** in 2023 has risen significantly

→ **Equities**: underweight given the risk of recession

→ **Bonds**: maintain short duration; increase share of IG and sell Chinese bonds in RMB

→ **Currencies**: USD downgraded

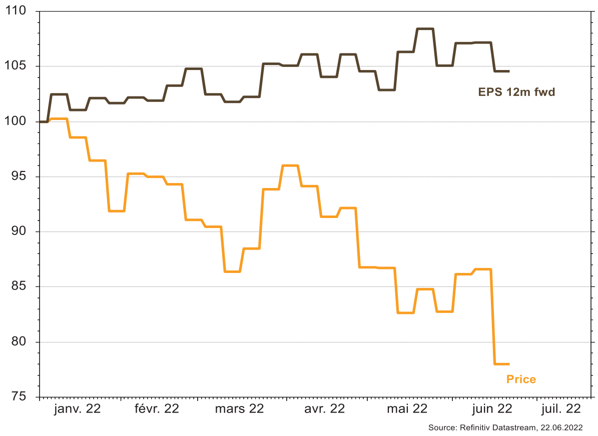
→ **Cash**: overweight

	UW (-)		N (=)		OW (+)
Asset allocation					
Equities		■			
Sovereign bonds		■			
Credit		■			
Alternative investments				■	
Cash					■
Equities					
US			■		
Europe		■			
Switzerland				■	
Japan		■			
Emerging markets				■	
Bonds					
Sovereign		■			
Corporate investment grade				■	
High-yield corporate	■				
Emerging market sovereign (USD)	■				
Emerging market sovereign (local)	■				

Economy: *is a soft landing possible?*

The **challenge** facing central banks is how to bring inflation back down to near-target levels without plunging the economy into recession.

Chart 1 | Global equities: decline in prices can be wholly blamed on the squeeze on valuations

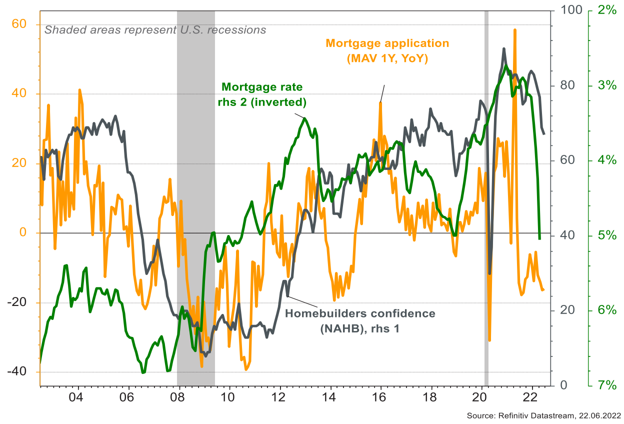


To avoid an **inflationary spiral** (prices rise → wages go up → prices rise → and so on), demand must be scaled back, which causes the unemployment rate to rise. Hiking interest rates is tantamount to putting the brakes on economic activity. On the rare occasions the Fed has successfully pulled off this manoeuvre, the efforts needed to rein in inflation were fairly modest. Striking the right balance is tricky at the best of times; this time around it looks set to be a mission fraught with danger. Indeed, so wide is the gulf between the current state of affairs and the Fed's targets that optimum calibration of monetary tightening to hit those targets without triggering a recession looks to be **beyond its reach**.

In the **US**, the latest inflation numbers put the annual rate at 8.6%, well above the 2% (average) target. Similarly, unemployment – which corresponds to the Fed's second mandate – stands at 3.6%, whereas the non-inflationary rate is considered to be in the vicinity of 5%. That being the case, monetary tightening looks set to be severe, with short rates now estimated to peak at around 4% (up from just over 1% at end 2021), and thus liable to trigger a recession next year. That means financial conditions – i.e. ease of access to affordable finance – also need to be closely monitored. Worsening financial conditions, linked in part to rising interest rates but also to widening corporate credit spreads and already much tighter commercial bank lending conditions, speed up the process of monetary tightening in the economy.

Housing is the front-line casualty of this new environment. Access to property ownership, measured taking into account home prices, interest rates and wages, has fallen back to its long-term average. Confidence among homebuilders is flagging and mortgage applications have slumped 20% this year (**Chart 2**). Lastly, while economic activity data is still satisfactory (retail sales up 1% MoM in May and up 8.2% YoY; industrial production up 1.1% MoM in April and up 6.4% YoY), leading indicators like the ISM indices and consumer confidence have begun their descent.

Chart 2 | US housing: rising interest rates are directly denting confidence in the sector



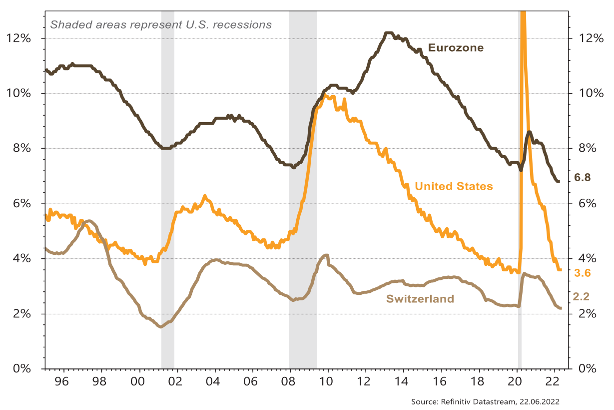
Financial markets

*) To 21.06.2022	Performance			Valuation			Earnings growth			
Equity markets	Price (local currency)	Quarter Q2*)	Since 31 Dec 2021	12-month P/EPS	Dividend yield	Price/ net assets	12-month EPS	2022 EPS	2023 EPS	2024 EPS
United States	3 577.69	-17.50%	-22.10%	16.26	2.2%	3.8	10%	10%	10%	9%
Europe	408.58	-10.40%	-16.20%	11.63	3.5%	1.7	9%	14%	5%	6%
Japan	1 856.20	-4.60%	-6.80%	12.08	2.5%	1.2	9%	10%	6%	9%
Switzerland	10 479.84	-14.00%	-19.00%	14.90	3.1%	2.7	11%	11%	11%	10%
United Kingdom	3 943.98	-5.80%	-6.30%	9.81	4.0%	1.6	8%	17%	0%	1%
Emerging Markets (USD)	1 016.98	-10.90%	-17.50%	11.07	3.6%	1.6	9%	10%	9%	9%
World (USD)	2 543.36	-16.70%	-21.30%	14.61	2.6%	2.7	9%	11%	8%	8%

Source: Datastream, IBES consensus

In the **eurozone**, the conflict in Ukraine is having a more direct impact on the economy. Energy costs are sky-high and government efforts to make them sustainable are further stoking inflation, which is into double figures in the Baltic states, Slovenia, Greece and the Netherlands and is averaging 8.1% YoY across the eurozone as a whole, a long way above the ECB's 2% target. As in the US, unemployment is historically low at 6.8% – its lowest since the creation of the single currency – and wage pressures are intensifying (**Chart 3**). Wages are now being raised (minimum wage in France, civil service pay in Germany, cost of living bonus for those on the "citizens' income" scheme and seasonal workers in Italy). All of this calls for the ECB to take action.

Chart 3 | Unemployment rate (US & Europe): the labour market is already tight



On top of those same challenges that are facing the Fed, the ECB must manage the risk of **fragmentation** among countries that share the single currency (by preventing financing costs from diverging between countries). The announcement in June that the ECB was halting its asset purchases and would be hiking interest rates for the first time in July resurrected this very problem. The spread between Italian and German financing costs has stretched from 1% at end 2021 to over 2.4%. Christine Lagarde is expected to step up her communication efforts in an attempt to reassure markets and prevent a return to the dark days of the 2011 debt crisis.

Although lower than elsewhere, inflation has not spared **Switzerland**. It came in at 2.9% YoY in May, its highest since 2008, forcing the SNB to raise interest rates by half a point in June (from -0.75% to -0.25%). Although the timing and magnitude of the SNB's move were a surprise, this rate hike is justified on fundamental grounds. The exceptional period of negative interest rates is finally set to draw to a close by the end of the year.

Still on the prices front, **food** inflation is worrying. The FAO Food Price Index is at an all-time high, with the least-developed countries and lowest-income households set to be hit hardest. By way of comparison, households in India and Indonesia allocate around 30% and 40%, respectively, of their total spending to food, while the equivalent figure in the US and Europe is only just over 10%. Unless prices come down, social unrest could exacerbate the economic situation in some emerging countries.

Against this general backdrop of monetary tightening and slowing economies, **China** stands out from the pack. Admittedly, the zero-Covid strategy has been a failure, economically speaking. Repeated lockdowns have curtailed activity and disrupted global supply chains. However, the recent reopening of Shanghai is good news. Similarly, the PBoC (China's central bank) has implemented more accommodative monetary policy, which it can do because inflation is low (at 2.1% YoY), and the state has put in place a policy of economic stimulus. After plummeting, purchasing managers' indices (PMIs) are beginning to pick up. Beijing should thus be able to enjoy the benefits of a more favourable economic climate.

10-year sovereign bonds	Level at 21.06.2022	Change Q2*) (bps)	Change since 31 Dec 2021 (bps)
USD yields – United States	3.30%	98	181
EUR yields – Germany	1.76%	125	194
JPY yields – Japan	0.24%	3	17
CHF yields – Switzerland	1.39%	85	152
GBP yields – United Kingdom	2.62%	103	164
Emerging markets (USD)	7.53%	169	288
Emerging markets (local currency)	4.51%	46	68
Commodities	Price	Quarter Q2*)	Since 31 Dec 2021
Gold (USD/oz)	1 838.50	-5.3%	0.9%
Brent (USD/bl)	111.94	6.3%	44.0%

FX	Level at 21.06.2022	Change Q2*)	Change since 31 Dec 2021
EUR vs. CHF	1.0180	-0.58%	-1.75%
EUR vs. USD	1.0566	-4.99%	-6.65%
EUR vs. JPY	143.8199	6.50%	9.82%
EUR vs. NOK	10.3648	6.53%	3.36%
GBP vs. EUR	1.1630	-1.73%	-2.38%
GBP vs. USD	1.2284	-6.71%	-9.31%
USD vs. CHF	0.9636	4.71%	5.76%
USD vs. CAD	1.2921	3.44%	2.29%
AUD vs. USD	0.6990	-6.92%	-3.86%

Source: Datastream

Monetary preferences

Rank 1	Rank 2	Rank 3
Appreciation expected	Stabilisation	Depreciation expected
CHF | EUR | GOLD	JPY | NOK | USD	GBP
▪ **CHF**: valuation is no longer excessive, interest rates are rising and the franc is a safe haven currency ▪ ↑ **EUR**: although some degree of political risk remains, the euro is attractively valued and the ECB is beginning to tighten monetary policy; fragmentation of the eurozone is a risk ▪ **GOLD**: a currency hedge and a diversification asset	▪ **JPY**: attractively valued ▪ **NOK**: stabilised now that oil prices have picked up ▪ ↓ **USD**: downgraded due to its high valuation and the fact the interest-rate differential relative to other currencies has peaked	▪ **GBP:** attractively valued but structural effects of Brexit not yet visible; moreover, BoE is set to raise interest rates to a lower level than originally expected

Investment conclusions

Our asset allocation **remains cautious** as we move into Q3. Fears over economic activity will prompt downgrades to the corporate earnings growth outlook and penalise the equities asset class. Indeed, the year-to-date decline in equity indices, although sizeable, is entirely down to the valuation squeeze (regime change) rather than to expectations of potentially shrinking economies. The risk of recession has thus not yet been priced into **equities**, justifying **our underexposure**.

The global monetary tightening that is underway will initially push up all interest rates. This movement has not yet run its course and provides justification for being **underexposed** to fixed-rate and long-dated **bonds**. Furthermore, while the **high-yield** segment has proved resilient (relatively speaking) during the early part of this phase, its performance is set to decline relative to **investment-grade** bonds as the growth outlook deteriorates. We have adjusted our portfolios accordingly by **increasing** our exposure to the more defensive IG segment, which now offers attractive returns, and have **reduced** our high-yield allocation. We have also **sold** our Chinese sovereign bonds in RMB (to take profits) as their upside has diminished. Moreover, the economic reboot in China is being accompanied by more expansive monetary and economic policy than elsewhere and could support domestic equities after their lengthy spell of underperforming.

Lastly, on the currency front, we think the **US dollar** is now nearing its peak: it has become expensive and, above all, its interest-rate premium over other leading currencies is close to an all-time high. The dollar is expected to depreciate.

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