BANQUE
ERIC STURDZA

QUARTERLY OUTLOOK
3RD QUARTER 2022

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1. EDITORIAL

WHICH SIDE TO CHOOSE?

Much has already been said about the first half of 2022. One of the worst for stocks, one of the worst for bonds and THE worst when combining the two asset classes as in the traditional 60/40 portfolios. As stocks and bonds plunged together, diversification was of no help. At the end of the day, the MSCI world index was down 19.6% and the Global Aggregate bond index was down 9.4%.

"Old traders always underestimate movements", they used to say... 2022 is the proof. The inflation trajectory, the late but nevertheless assertive shift in central bank policy made the bond market decline inevitable... But few expected to such a magnitude, and the induced effects were also underestimated. The wake-up call has been brutal, but now it seems that - at least on the interest rate side - the months ahead are correctly forecast. Whether Jerome Powell raises 0.75% or 0.5% at the next FED committee is not so concerning, what matters more is the trajectory that should take us to around 3.5% by March 2023.

Harder to anticipate, however, are the consequences that these rate hikes will have on the economy. Opinions differ radically. The *"macroeconomic side"* is very pessimistic: William C Dudley (former member of the FED) says that recession is inevitable, Jamie Dimon (head of JP Morgan) expects an *"economic hurricane"*... We could multiply the examples of these experts who are convinced that with inflation so high and unemployment so low, the central bank will not be able to avoid the economy entering a recession in order to break the price dynamics

On the other side – the side of the business community or microeconomics – opinions are less negative. During the major conferences organized by intermediaries in June, the companies interviewed were still quite positive... And some CEOs were frankly enthusiastic, like the CEO of L'Oréal who declared: *"After Covid we are in a carpe diem environment and today carpe diem trumps inflation"*.

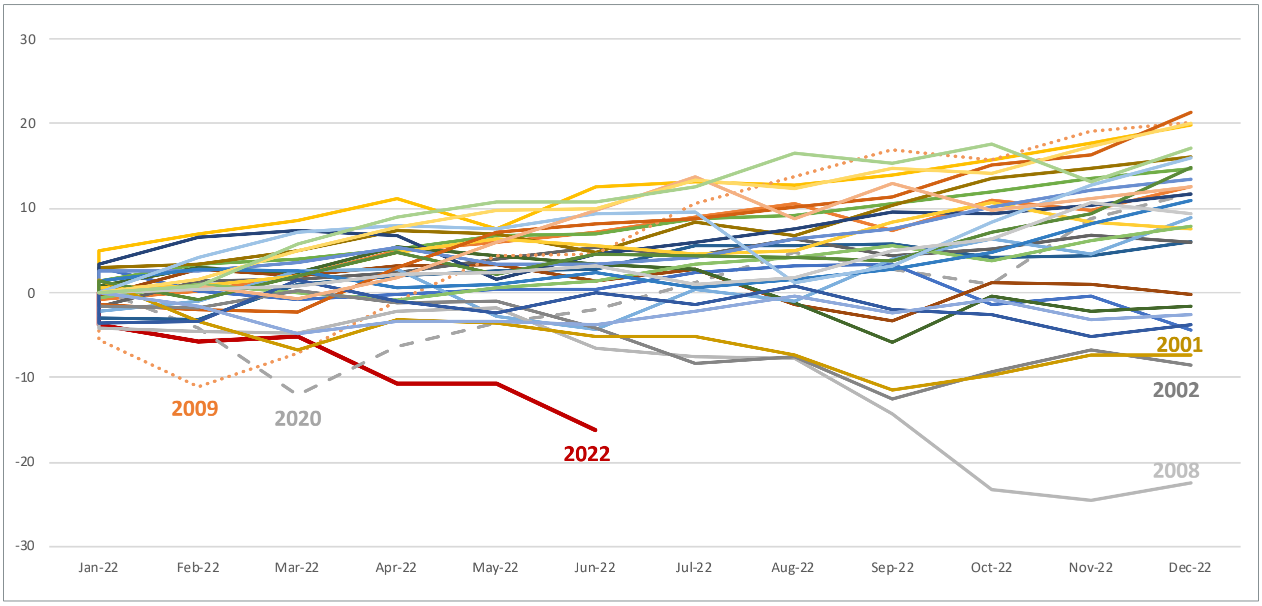
All this produces an astonishing conundrum: macro-economists are expecting a recession, but companies' earnings growth expectations are still very positive. As our Anglo-Saxon friends would say, *"something has to give..."*.

If the companies are right, the markets will fall, and the STOXX 600 for example, will return to the valuation levels of January 2019 (PE forward of 12). This will certainly provide good opportunities. If, on the other hand, the recession is unavoidable, further downward adjustments are to be expected (remember that on average the Standard and Poor's falls by 30-35% during recession!)

Integrating these two scenarios leads to maintaining a "reasonably conservative" allocation approach to both Europe and the United States.

Integrating these two scenarios leads to maintaining a *"reasonably cautious"* allocation approach with regards to both Europe and the United States. Conservative because the risk of recession is real, and cautious because the message from companies must also be heard.

G1 : YEARLY PERFORMANCES OF A PASSIVE DIVERSIFIED PORTFOLIO – 60% EQUITIES / 40% FIXED INCOME OVER THE PAST 30 YEARS



Source : Bloomberg, Banque Eric Sturdza, 60% Actions (MSCI World USD NR) / 40% Taux (Global Aggregate USD hedged

In addition to this somewhat lacklustre positioning, we should not forget the rest of the world inlcuding China. The economic cycle is radically different there, the country is just reopening, inflation is at 2%, the government is stimulating the economy by lowering loan rates and paying bonuses to car buyers... Taking away radical regulatory measures makes us much more positive on this region, where valuations are also very low (the MSCI China is trading on a PE of 12.5)...

We are lukewarm on the US and European markets, and more confident about China. If we were to add a joker to the pack, it would undoubtedly be Japan, where the valuation of companies coupled with a very weak currency make the equity market potentially very attractive.

2. MACRO FOCUS
FROM STAGFLATION TO RECESSION.

This is the sentiment to emerge from the month of June. Over the past 12-18 months, inflation has accelerated sharply, initially as a result of the economic recovery post-COVID, supply chain disruptions – and more recently as a result of Chinese lockdowns. The conflict in Ukraine is amplifying the commodity supply shock. With a more pronounced deceleration in growth and this higher inflation, it was indeed the specter of stagflation that worried us up until a few weeks ago. The market focus has now clearly switched to the recession risk.

If the normalization of price increases is slow in coming, it is now the fear of seeing the FED – and other central banks – *"do too much"* by raising rates too high and adopting a too restrictive monetary policy. By wanting to *"kill"* inflation at all costs, it is growth that risks paying the price and it is this scenario that market participants have begun to price in recent weeks, as evidenced by the recent decline in commodity prices. Supply remains constrained and the sanctions imposed on Russia do not help, but an economy in recession would imply a lower demand and price equilibrium at a lower price level. Let's remember that in 2020, the Brent barrel was averaging $40 for the year on similar recession fears.

After some early complacency, macro forecasts have adjusted. Global growth expectations have been slashed by 1.2% between end-2021 and end-June 22, this adjusted figure nonetheless represent an economic growth that has been almost halved from 2021. Russia is expected to suffer a contraction of nearly 10% of its economy, a shock three times greater than it experienced in 2020. Unsurprisingly, European countries, led by Germany, are among the economies where the economic slowdown is most pronounced. With such sluggish growth, the risk of recession is increasing, especially for countries such as the US and France, which have already experienced a decline in Q1 and may experience a *"technical"* recession in the event of a repeated decline in Q2. According to the FED's 2nd quarter GDP NOWCAST, the US economy might already be in *"technical"* recession...

By wanting to "kill off" inflation at all costs, it is growth that risks paying the price, and this is the scenario that market participants have begun to predict in recent weeks, as evidenced by the decline in commodities.

A ray of hope in the middle of this landscape is China, which remains a case apart. While China's GDP is expected to contract in Q2, this appears to be the result of self-inflicted pain with the implementation of further Covid lock-downs and the disruption this caused. With a gradual end to these lockdowns, economic activity is expected to pick up and start to normalize. This recovery could benefit from selective stimulus measures and an accommodating central bank – in contrast to the FED – which still has significant room for manoeuvre and whose economy is less prone to inflationary pressures.

TABLEAU 1 : GROWTH AND INFLATION FORECAST 2022 - DECEMBER 21 VS. JUNE 22

			Initial Forecast	June Forecast	
	2020	2021	2022e	2022e	Old vs. New
World	-3,1%	6,1%	4,4%	3,2%	-1,2%
USA	-3,4%	5,7%	3,9%	2,6%	-1,3%
Euro Zone	-6,4%	5,3%	4,2%	2,8%	-1,4%
- Germany	-4,6%	2,9%	4,2%	1,8%	-2,4%
- France	-7,9%	7,0%	4,0%	2,6%	-1,4%
- Italy	-8,9%	6,6%	4,5%	2,8%	-1,7%
- Spain	-10,8%	5,1%	5,8%	4,4%	-1,4%
Switzerland	-2,5%	3,8%	2,9%	2,5%	-0,4%
United Kingdom	-9,3%	7,2%	4,9%	3,6%	-1,3%
Japan	-4,6%	1,8%	2,9%	1,8%	-1,1%
Emerging Economies	-0,6%	6,5%	5,0%	3,7%	-1,3%
Asia ex Japan	1,4%	5,6%	5,5%	4,7%	-0,8%
- China	2,3%	8,1%	5,3%	4,2%	-1,1%
- India	-6,6%	8,7%	9,2%	7,3%	-1,9%
Latin America	-6,1%	8,1%	2,1%	2,2%	0,1%
- Brazil	-3,9%	4,8%	1,1%	1,0%	-0,1%
EMEA	-2,8%	5,4%	3,5%	-1,7%	-5,2%
- Russia	-3,0%	4,7%	2,5%	-9,7%	-12,2%
CPI					
- USA	1,2%	4,7%	3,8%	7,5%	3,7%
- Euro Zone	0,3%	2,6%	2,4%	7,2%	4,8%
- UK	0,9%	2,6%	2,5%	8,3%	5,8%
- Japan	0,0%	-0,3%	0,7%	1,9%	1,2%
- China	2,5%	0,9%	2,2%	2,2%	0,0%

Source : Bloomberg, FMI, Banque Eric Sturdza

Split between stagflation and recession risks, the economic situation calls on us to maintain a relatively balanced and cautious asset allocation: We are nevertheless maintaining a strong focus on China and Japan, which seem to us to be relatively less affected by the inflation issues – and to a lesser extent – to benefit from significant fiscal and monetary support factors. These are also areas where the equity markets seem to have already discounted their share of bad news.

3. FIXED INCOME
RECESSION AND FRAGMENTATION RISK.

Fed: neutral or restrictive?

The Fed's monetary policy will go through two periods. In the first, it will move from accommodative to neutral. The second will go from neutral to restrictive. The markets believe that a neutral mode will probably be reached after 75bp of Fed funds hike (50 on July 27 and 25 on September 21). These theories do not take into account the QT that started on June 1st. Underestimating its impact could lead (in our opinion) to a misjudgment of the timing in the transition from neutral to restrictive and of the definition of the neutral mode. Believing only in a soft landing scenario seems naive and could be wrong. The Fed is well aware that a soft landing may not be effective enough to really bring down inflation. Only a recession seems compatible with the Fed's ambitious inflation targets. The US Treasuries yield curve is telling us that a recession is coming, with a 2-10 year curve flirting with flatness as well as an inverted 5-10 year and 5-30 year curve.

The ECB in "whatever it takes" mode

The ECB is not the Fed and therefore will have to take into account the potentially catastrophic ripple effects of a restrictive monetary policy modelled on that of its Washington counterpart. The ECB's *"last minute"* meeting made it clear. Inflation will be fought, but there is no question of letting the spreads of periphery countries blow up. There is a risk of fragmentation that the eurozone cannot afford, first and foremost for the countries concerned!

Meanwhile, the SNB has managed to raise rates by 50bp, a move that surprised by its magnitude and timing in a country where the inflation index has "only" increased from 1.5% to 2.9% since the beginning of the year.

There is a risk of fragmentation that the eurozone cannot afford, first and foremost for the countries concerned!

TARA: Favoring dollar-denominated investment grade assets

The first half of 2022 is coming to an end, and investors have suffered quite badly. However this suffering offers opportunities for the second half of the year with a possible return to better fortunes for fixed-income investors. Performance has been disastrous and by mid-June the dollar Investment Grade Credit Index was down 15% YTD.

Yields have tightened significantly. Our Core bond strategy now shows a yield of 5% for a duration of 4 years! TINA has therefore logically disappeared in favor of TARA – There Are Reasonable Alternatives. Among the options proposed by TARA, it is indeed the high quality credit (Investment grade) with a medium duration in dollars that should be favored to the detriment of Emerging Markets and especially High Yield. Traditional IG bond picking is now back for good, it represents without question one of the major pillars of TARA.

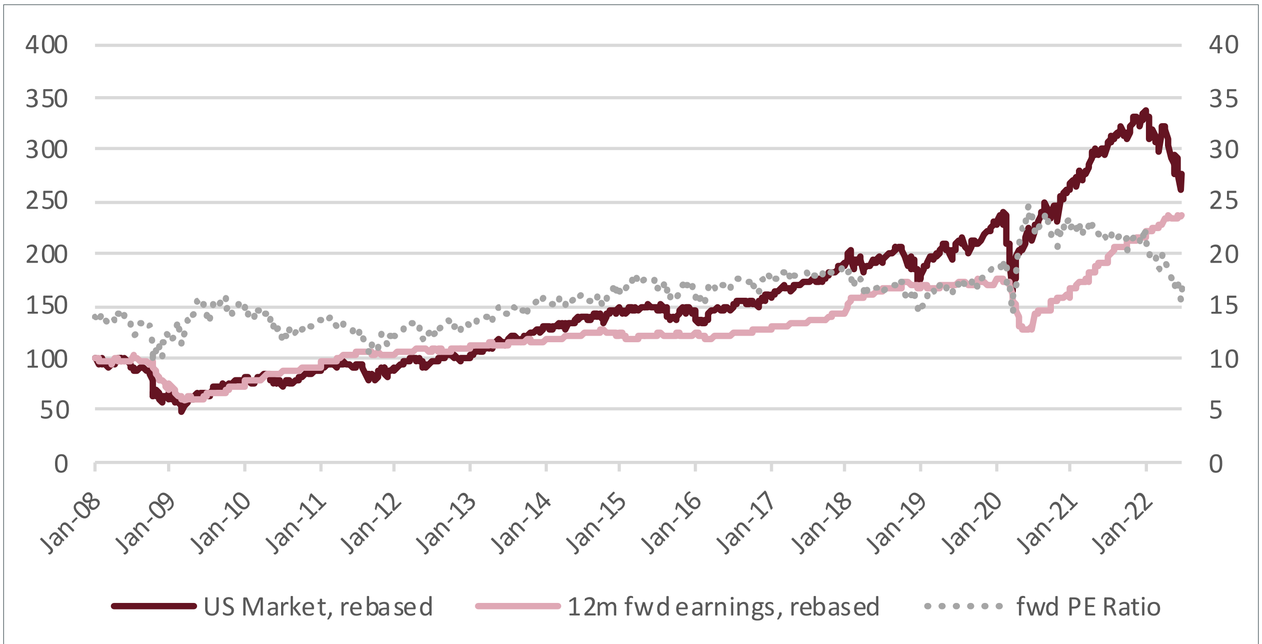
4. EQUITIES MARKETS

MARGIN PRESSURES? FAVOR QUALITY.

After a welcome lull in May, equity markets went into sharp correction in June. This following the publication of higher than expected US inflation figures. The Federal Reserve's response was swift with a 75bps rate hike. As mentioned in our last commentary, with the debate now focused on earnings and less on multiples, Mr. Powell's comments were worrisome because of the intention they revealed: to slow down the economy, at the risk of causing a recession. The equity market's response therefore followed this logic, correcting equity prices further for the more cyclical energy sector rather than technology, a real change in trend.

In line with these dynamics and on the eve of the publication of quarterly results, the increase in analysts' explicit expectations is notable and diverges from investor sentiment. Indeed, while the US market correction has reached about -20% to date, it has so far taken place in the context of an increase in the US real 10-year rate from -1.04% to +0.72%, impressive and rare quanta, but consistent with each other. In other words, while valuation multiples now reflect higher real interest rates, these multiples seem to be based on consensus earnings expectations, which remain surprisingly unchanged.

G2: PERFORMANCE S&P500 VS. 12M FORWARD EARNINGS ET FWD P/E



Source: Bloomberg, Banque Eric Sturdza, base 100 Janv. 08

If we look at it a little closer; if stock performance can be broken down into earnings per share growth, multiple expansion potential, and dividend, the analyst consensus is indeed off when it comes to earnings per share.

The divergence between analysts' earnings expectations and the market's palpable concerns only increases our belief that a "quality" investment style should prevail on equities.

The important component is profit margin and cost inflation coupled with weakening demand would likely hurt it. Remember that this profit margin has grown from 9.4% to 11.6% in the US and from 6.5% to 8.8% in Europe, from 2020 (pre-covid) to today. Let's also remember that producer price indicators (PPI) are now outpacing consumer price indicators (CPI), indicating a divergence between cost and revenue trajectories, and that historical statistics show that if there were a recession, it would not bode well for margins, which are down 0.8% to 1.8% depending on past episodes.

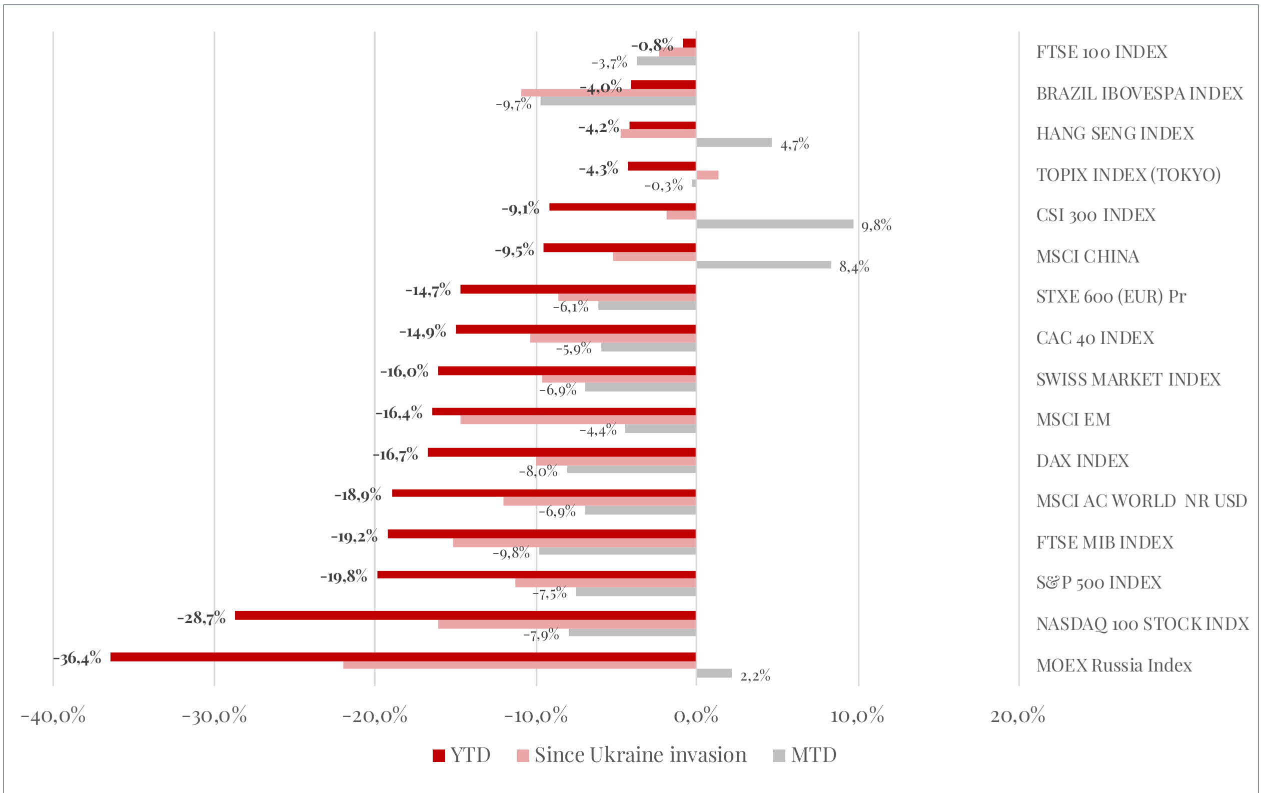
This divergence between analysts' earnings expectations and the market's palpable concerns only increases our conviction that a *"quality"* investment style should prevail on equities.

The intensity of the correction in quality stocks is historic, and a consequence of a complex and rare inflationary dynamic, leading to a lagging monetary policy. But let's not throw the baby out with the bathwater: the current situation, inflationary in the short term and possibly recessionary in the medium term, significantly increases the likelihood of pressure on margins, in remarkable contrast to this confident consensus. The so-called "quality" companies should make the difference because of their prototypical characteristics: low debt, ability to raise prices and defend margins, low-cyclical end markets, stable growth.

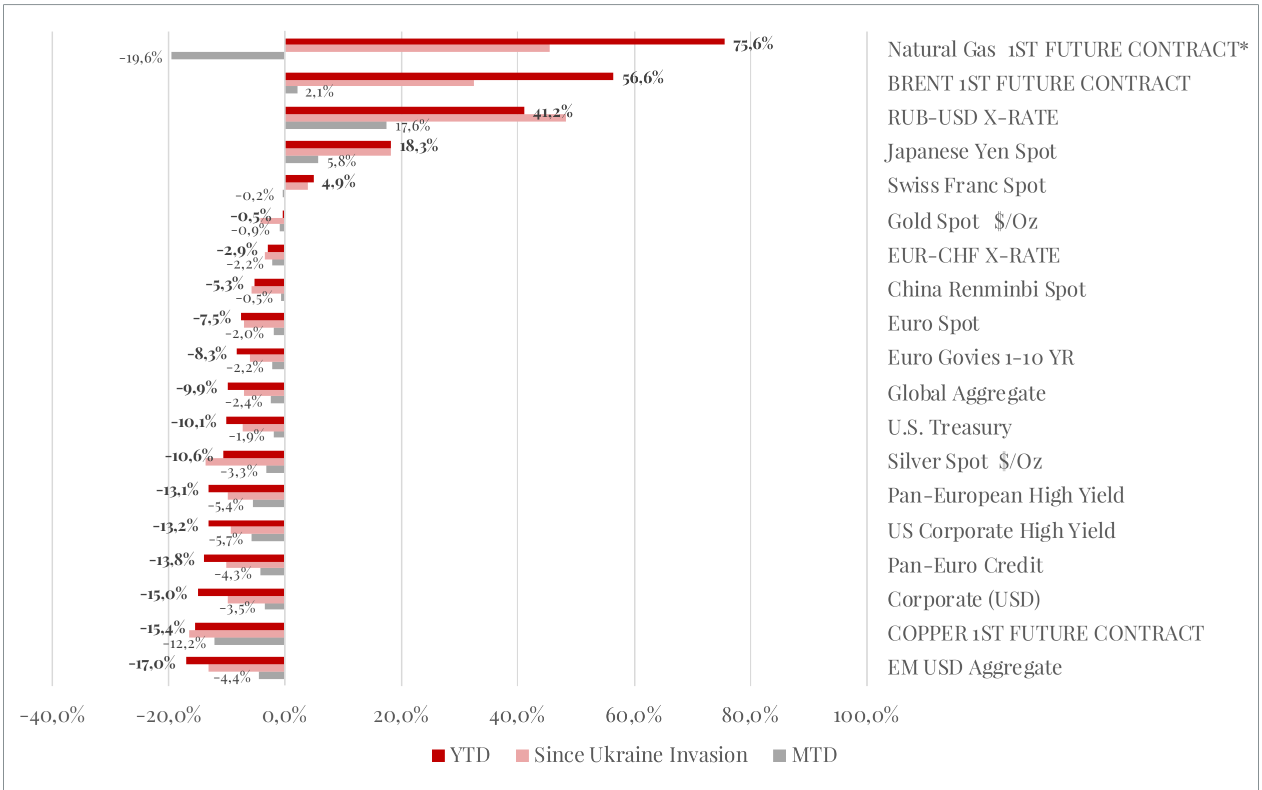
While these attributes have in the past had the corollary of generating valuations that were sometimes too excessive in a low interest rate environment, it seems that the correction has now taken place, and our reading of the environment suggests that their strengths should once again become an important source of differentiation in view of the risk to the cycle and to margins.

6. PERFORMANCES

EQUITIES IN LOCAL CURRENCIES



FIXED INCOME, CURRENCIES AND COMMODITIES



Source : Bloomberg, Banque Eric Sturdza, 28/06/22

** 75 % YTD*

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