BANQUE
ERIC STURDZA

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SEPTEMBER 2022

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1. EDITORIAL

SUMMER HEAT.

July was marked by high temperatures and booming stock markets. With August we are entering a more delicate phase: storms and more nervous markets. Two drivers fueled the early summer rally: an overly cautious initial positioning on the part of investors and a very good earnings season.

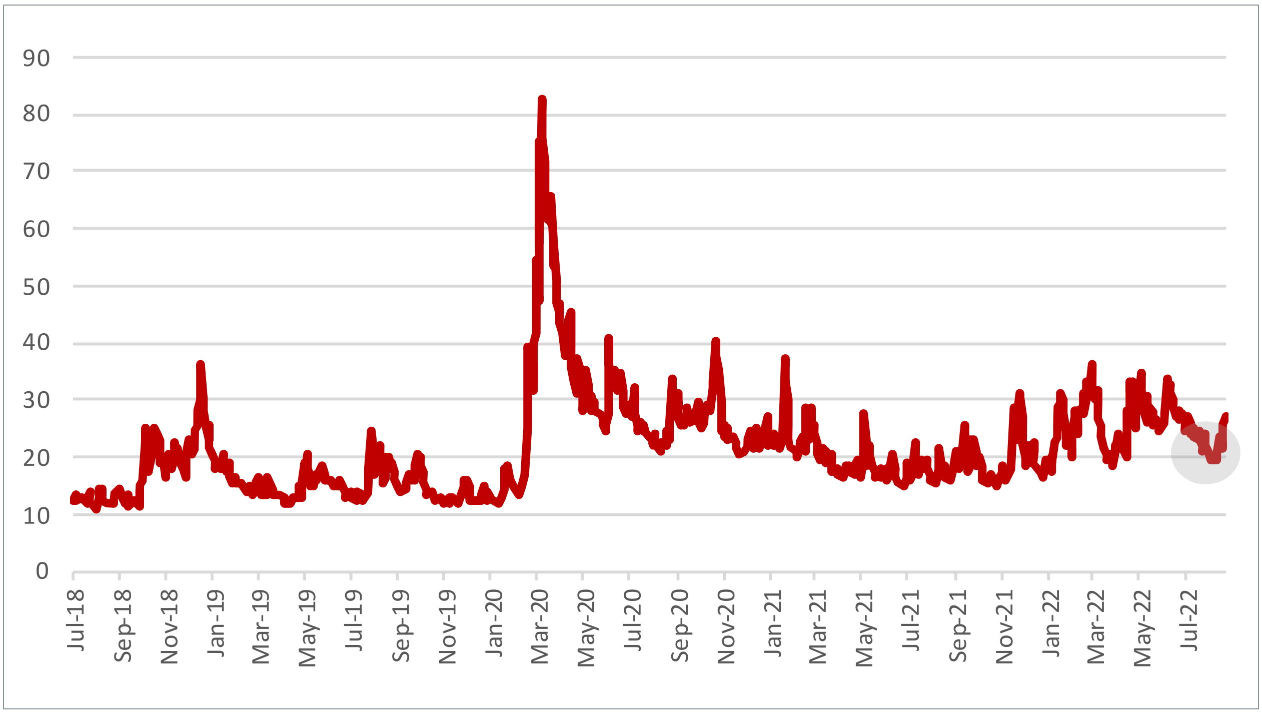
At the beginning of August, a third favorable factor added to the positive momentum. For the first time in a long time, there were finally some positive surprises on the inflation front! The market welcomed the somewhat lower U.S. July CPI figure (consumer prices) released on August 10th and this was reinforced by the producer price index published two days later (-0.5% in July). This gave the idea of having passed the inflation peak, expectations for US interest rates adjusted, and the 75 basis point rate hike in September seemed less certain, which pleased the equity markets and growth stocks in particular. What a rally for the Nasdaq, which – from its low point on June 16 – finally recovered over 20%!

Some form of confidence seemed to return in the ranks of investors, reflected by a softening VIX. For the first time since the beginning of the conflict in Ukraine, the VIX fell below the 20 mark.

In order to forecast the weeks ahead, we must re-examine each of the three factors that have supported the markets in the recent period.

Investors are obviously less risk averse today and the market sentiment is more in buying mode. The VIX mentioned above is proof of this: below 20, it marks a lesser degree of concern, if not a return to serenity.

G1 : VIX INDEX



Source : Bloomberg, Banque Eric Sturdza

This positioning is sometimes schizophrenic because, while buying stocks, 75% of investors remain convinced that the onset of recession is imminent.

The future path of inflation is a more complex picture. Are we sure that the July improvement marks the peak of inflation? As for long term rates (inversely correlated to equity markets), they were a bit hasty. At 2.50% at the beginning of the month while inflation was at 8.5% year-on-year, isn't there a bit of complacency from fixed income investors? That would be our view and indeed from the beginning of August the 10 year rate has been incrementing step by step (around 3.1% at the time of writing).

Finally, there is the question of company earnings. The earnings season is now over and the share buyback window is open again. In the US, the amount of share buybacks by companies are estimated at 5 USD billion per day. This is certainly a supportive factor for equity markets, but it is already somewhat integrated by the markets. The positive surprise effect linked to the micro-economy, which was very significant in July, is behind us; the "micro" factor should remain neutral until we see third quarter publications.

In conclusion

Markets oscillate between periods dominated by the fear of losing and others dominated by the desire to succeed. "Greed and Fear" as market participants used to say... July marks the end of a period of excessive fear. In that respect, August appears to be a transition month, careful enough not to let the pendulum swing too far and fall into "Greed" territory. The very strong rebounds are more like profit-taking points... The Fed's fight against inflation is not over. We are waiting for the Jackson Hole summit and the next FOMC without excessive pessimism but aware that the summer rally leaves little room for disappointment.

2. FIXED INCOME
NO SURPRISE AT JACKSON HOLE.

A (still) resilient economy but an inflation way too high

At the beginning of the month, the release of US employment and inflation figures came as a positive surprise to equity and credit markets, confirming the resilience of an economy still supported by a strong labor market and robust consumption. Despite these encouraging figures, the Fed has not yet won its battle against inflation, as recent data indicates it is still well above its 2% target. The Fed Chairman Jerome Powell's statements at the Jackson Hole symposium confirmed the prior statements of some Fed members, namely the FED's willingness to make monetary policy more restrictive until its price stability objective is achieved even if it means sacrificing employment. Thus, further rate hikes are expected between now and December which, combined with an accelerated balance sheet reduction program, will lead the economy to slow down sooner than expected and increase the recession risk. Against this backdrop, the US 10-year yield, which stood at 2.65% at the end of July, has risen above 3%, with the 2-10 year yield curve remaining inverted. Even if it is difficult to know whether long term rates have peaked, market volatility will persist as long as inflationary pressures are not brought under control.

The ECB in the wake of the FED

With inflation remaining stubbornly high, the ECB has no other option to pursue its rate hike cycle, although the growing recession risk in the Eurozone (led by Germany and Italy) may compel the ECB to end its rate hike cycle earlier than expected. The ECB's recent comments following the release of the inflation figures have pushed up the short end of the curve more specifically, triggering the underperformance of EUR fixed income markets over the month. The release of the Eurozone PMIs (purchasing manager indices) showed a clear downturn in the overall economic activity, pointing to a growth contraction by the end of the year. With an economic outlook clouded by rising inflation and fears of gas supply cuts this winter, the ECB at some stage will have to re-assess the pace and the scope of its monetary policy normalization.

Fixed Income Strategy

As uncertainties remain high, we have not changed our positioning and are still eyeing a stabilization or even a decline in long-term rates sooner rather than later. With regards to credit markets, we continue to favor a prudent and selective approach. As we await a further slowdown in the main economic indicators, we expect volatility to rebound and spreads to widen again, which should provide us with good investment opportunities. In this environment, we remain focused on Investment Grade credits with a preference for the short end (2 to 3 years) and expect to moderately increase modified duration depending on market developments and central bank developments.

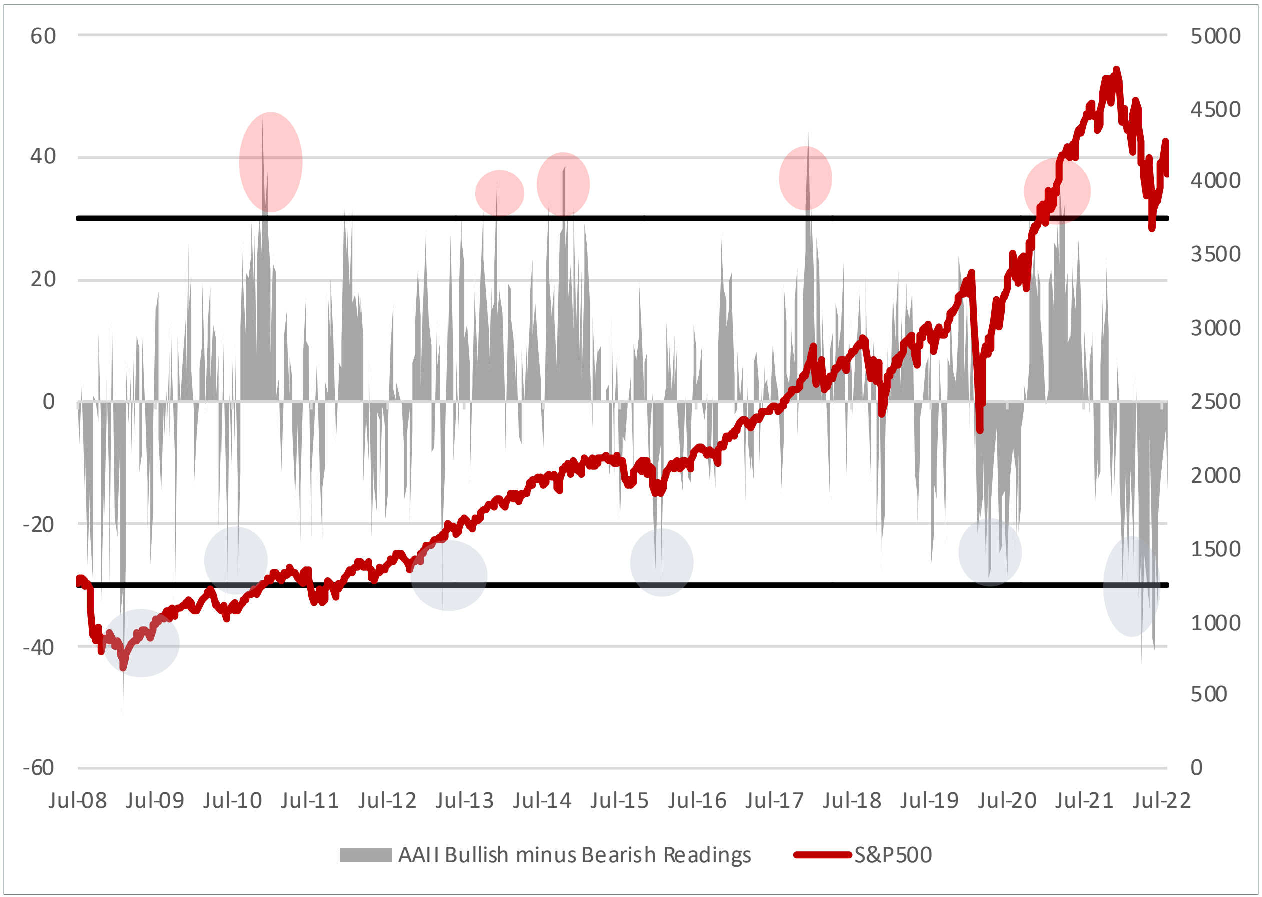
3. EQUITIES
TIME FOR A BREAK?

After an historic rebound in July, August proved more turbulent. The beginning of the month was a continuation of July, with equity markets still buoyed by generally good quarterly results. The release of a somewhat lower increase in July's consumer price index fuelled investors' hopes of peak inflation and subsequent hopes of a more accommodative Federal Reserve.

Towards a FED's pivot?

On this last point, Jerome Powell's unambiguous speech at the Jackson Hole symposium dashed hopes. He reaffirmed that a more significant and lasting drop in inflation would be necessary for the Fed to adjust its monetary policy and that rate hikes would continue, even if it meant causing damages to the US economy. It did not take much to trigger a 3% daily drop of the S&P500 erasing in a single day all the gains made in August.

G2: SPREAD BETWEEN AAII "BULLISH" AND "BEARISH" READINGS VS. S&P500



Source: AAII, Bloomberg, Banque Eric Sturdza

While the FED's pivot may take some time, the same cannot be said of the People's Bank of China, which decided to cut two of its main key rates for the second time this year, in a move designed to support a real estate sector still facing serious difficulties, but which also helps to reassure investors and allows Chinese markets – and in particular those of companies listed on domestic markets – to stabilize after a month of July that was rather at odds with other major international equity markets.

Market and investor sentiment turnaround?

If the good earnings season and the hope of a FED pivot are the fundamental drivers behind the equity market turnaround, the extremely pessimistic investor sentiment and the rather "bearish" positioning of equity investors also explains the unprecedented magnitude of the rebound. If these "contrarian" indicators nourished hopes for a technical rebound a few months ago, the signals sent by the same indicators are now much less clear-cut: The VIX, the fear index, fell back below 20% early August and while only 19% of investors surveyed at the end of June were "bullish" compared to nearly 60% of bearish investors, 27% and 42% respectively of investors surveyed were bullish and bearish at the end of August (see chart 2)...

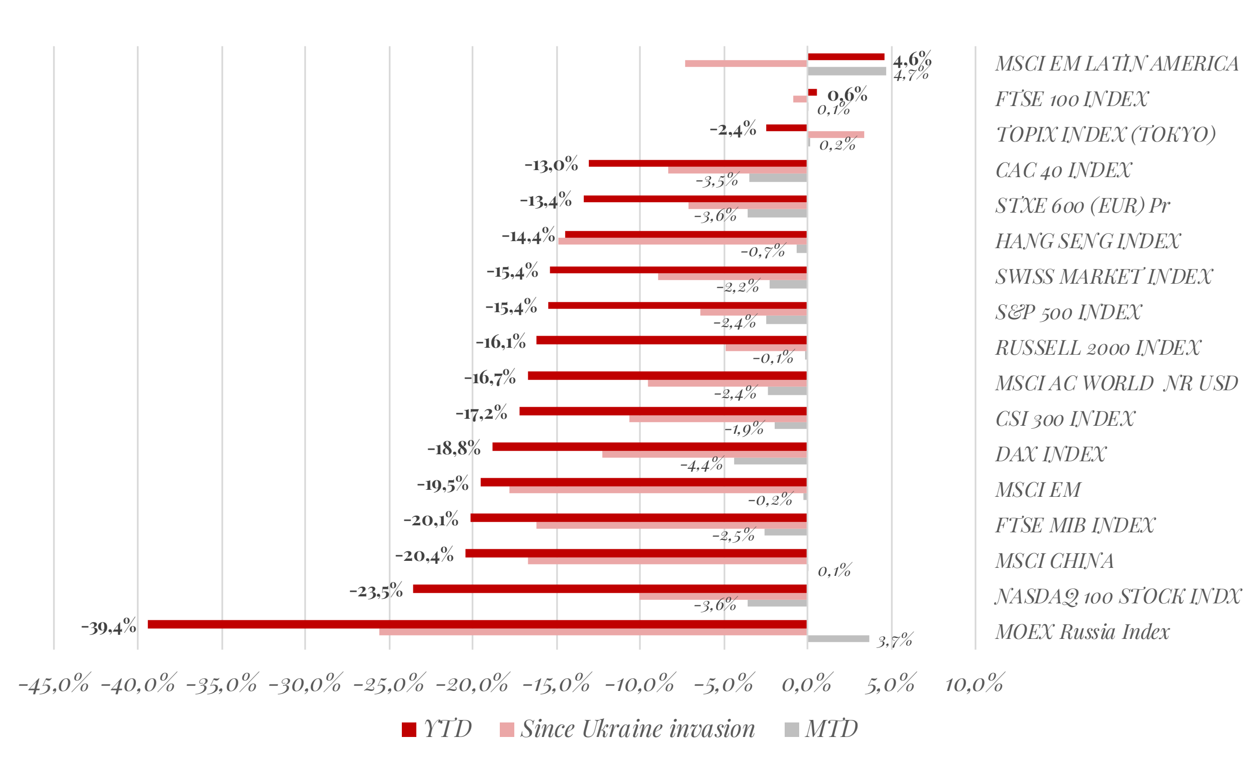
Equity markets and mid-term elections

Speaking of technical factors, it is difficult to avoid the debate about the S&P500 trading and performance patterns during mid-term election years. From this point of view, 2022 confirms the reputation of this mid-term year as the most difficult year of the presidential cycle performance wise... With inflation at its highest level in 40 years and a slowing economy, it remains to be seen whether the Inflation Reduction Act passed mid-August will be enough to save the slight Democrat majority in Congress. At $437 billion, the plan falls far short of the initial ambitions of the Build Back Better Act ($2,200 billion), but like in other regions, it heavily promote renewables and also aims to encourage domestic energy production. A slight but nonetheless a boost for the sector. While the mid-term year is known to be difficult, the post-election rally is also a classic of its kind, time will tell if a new Republican majority less inclined to raise taxes on coporates and HNWI could prove a catalyst.

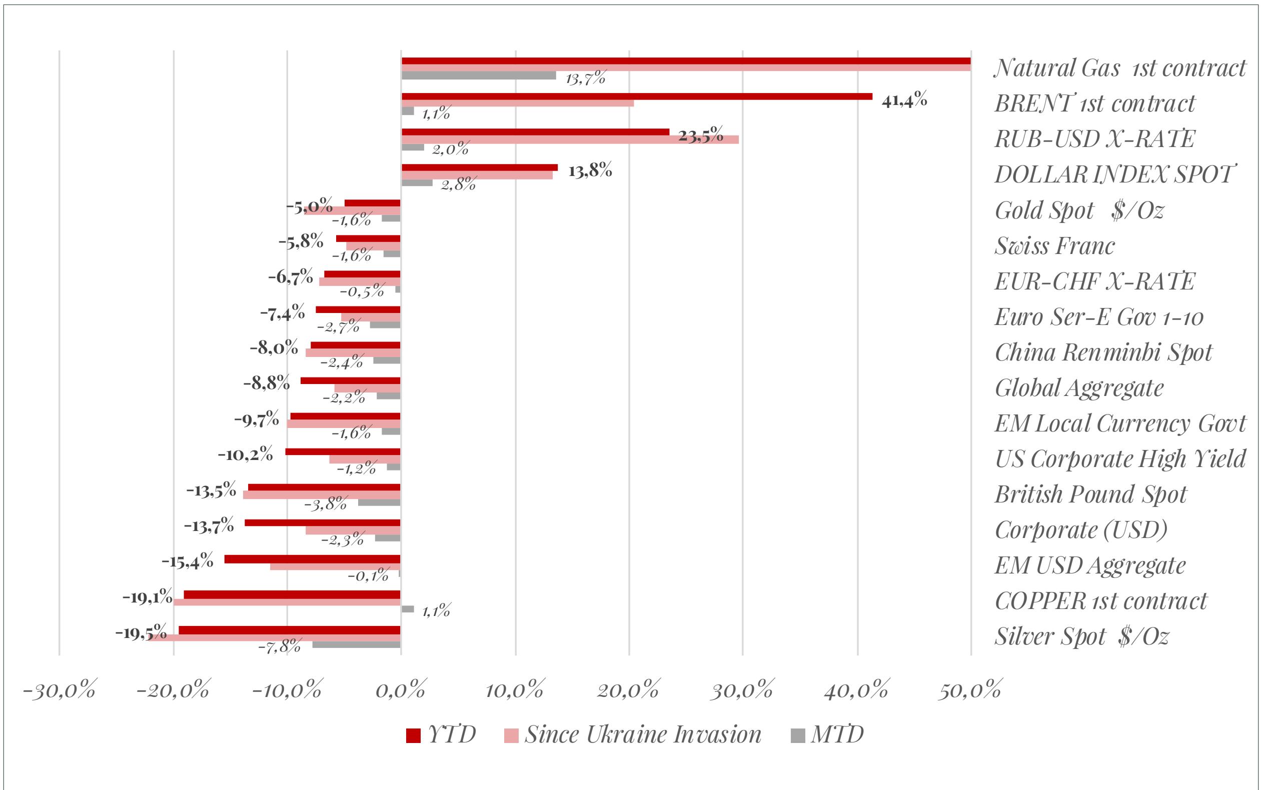
With a quieter period ahead for companies, a pivot shift that may take some time to materialize and a less extreme positioning, caution remains the order of the day, especially as elections could prove another source of volatility in a year they are not lacking therein.

5. PERFORMANCES

EQUITIES IN LOCAL CURRENCIES



FIXED INCOME, CURRENCIES AND COMMODITIES



Source : Bloomberg, Banque Eric Sturdza, 29/08/2022

** Natural Gas +120% YTD.*

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