BANQUE
ERIC STURDZA

QUARTERLY OUTLOOK

4TH QUARTER 2022

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1. EDITORIAL

KEEP AT IT.

In our last column, we mentioned the fact that market participants were undoubtedly going too fast in judging that inflation would soon be under control. On September 13th, the release of the Core CPI (Consumer price index excluding food and energy) up 0.6% for August and 6.3% year-on-year dashed the hopes of the most optimistic... and equity markets. Without surprise, Jerome Powell announced a few days later a 0.75% rate hike and "pre-announced" that two more hikes were in the pipeline: It will take time to curb inflation.

Historically, interest rates have been an important explanatory factor of asset prices in general and stocks in particular, but today they have become THE key driver. From now on, the level of interest rates relegates all other factors to the background.

The September hike was the fifth consecutive one and the third in a 0.75 bp step. This is an unprecedented pace, as we have to go back to 1994/95 to observe such a sharp increase (the central bank raised rates 7 times in one year, from 3 to 6%). Let's go back in the past for a while. "We will keep at it" said Jerome Powell during his speech. The expression marks a strong determination but is above all a discreet tribute to Paul Volcker. President of the Federal Reserve from 1979 to 1987, Paul Volcker is remembered for having "killed" inflation in the early 1980s by bringing it down from 15% to 3%. "Keep at it" was one of his favorite expressions, and was the title of one of his books*.

Jerome Powell's message could not have been clearer... Whatever the geopolitical situation or simply the risks of an economic slowdown, the rate hike cycle will continue until inflation is under control.

This is not encouraging for the asset allocator: rising interest rates weigh on multiples and – when led too hastily – they slow down the economy, causing ultimateky its fall into recession.

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One comment in order not to sink into an absolute pessimism: a credit portfolio mixing Investment grade and High yield bonds in equal parts now yields more than 7%, so that the implicit default rate assumed is very high! The observation is even more pronounced when we look at bank debt. With a portfolio mixing different levels of seniority we can achieve a 10% yield. To say it bluntly, the recession is already priced.

The same comment is only partially true for equity markets, where earnings expectations have yet to adjust downwards (a remark that should be refined given the wide disparities between styles and geographies). Nevertheless, the multiple compression mentioned earlier is well underway, particularly in Europe and Asia!

To conclude: investors would be well advised to focus again on credit markets as of now and be ready to consider equity markets in the future.

* *Keeping at it The quest for sound money and good government.*

2. MACRO FOCUS

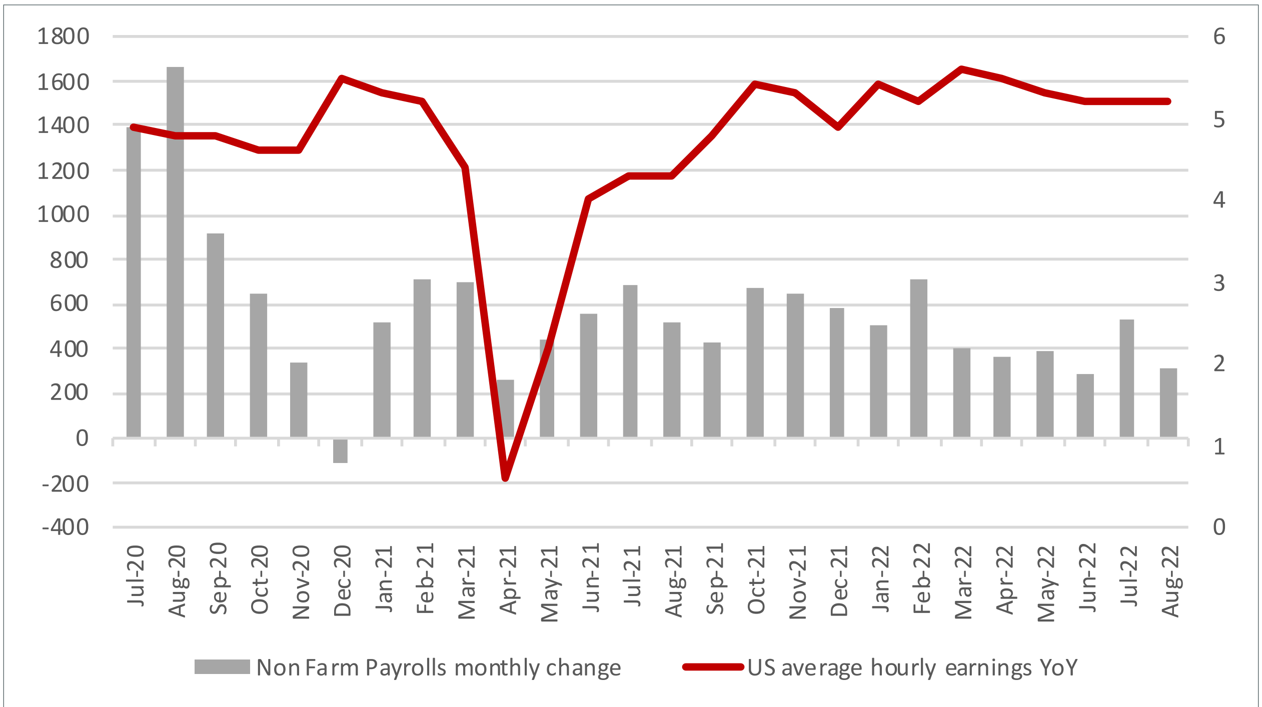
INFLATION, INTERVENTIONS AND RECESSION.

It is tough to look ahead to the next few months without mentioning this triptych. First, there is inflation, which remain the major issue for central banks and the Federal Reserve in particular. Secondly, there are the interventions that are beginning to flourish either from governments to tackle the energy crisis, or from central banks to stabilize financial markets and stop any major currency slide. Lastly, this is the combination of these factors that could propel us into a recessionary scenario.

Inflation again and again

Having been very (overly) complacent towards inflationary risk, the Federal Reserve has hardened its stance: a third consecutive 75 basis point hike, the prospect of two more, and without mentioning the reduction of the FED balance sheet at a steady pace... Jerome Powell announced his intention to push short-term rates into restrictive territory and indicated that an increase in unemployment consistent with a fall into recession would be necessary to "kill" inflation. After the slight decrease from 9.1% to 8.3% in the headline inflation, it is the Core that is of concern. While the recent drop in commodity and freight prices amid recession fears and less impressive base effects provide hope, the latest CPI release reminds us that any decline in core inflation (ex energy and food) will take longer. With the labor market still very robust, wage inflation continues to spread into services.

G1 : MONTHLY NON FARM PAYROLLS (LHS / THOUSANDS) AND AVERAGE HOURLY WAGE GROWTH YOY (RHS)



Source: Bloomberg, Banque Eric Sturdza

With respective rate hikes of 75bp by the ECB and SNB and 50bp by the Bank of England, other major central banks are not left behind either, even if the prevailing logic is not necessarily the same. In the Eurozone, inflationary pressures remain very much linked to the energy crisis and commodity prices. As such, the ECB's decisions are primarily targeted towards the negative externalities of this crisis, most notably on the imported inflation, while trying at the same time to avoid the explosion of periphery spreads.

Fiscal and monetary interventionism

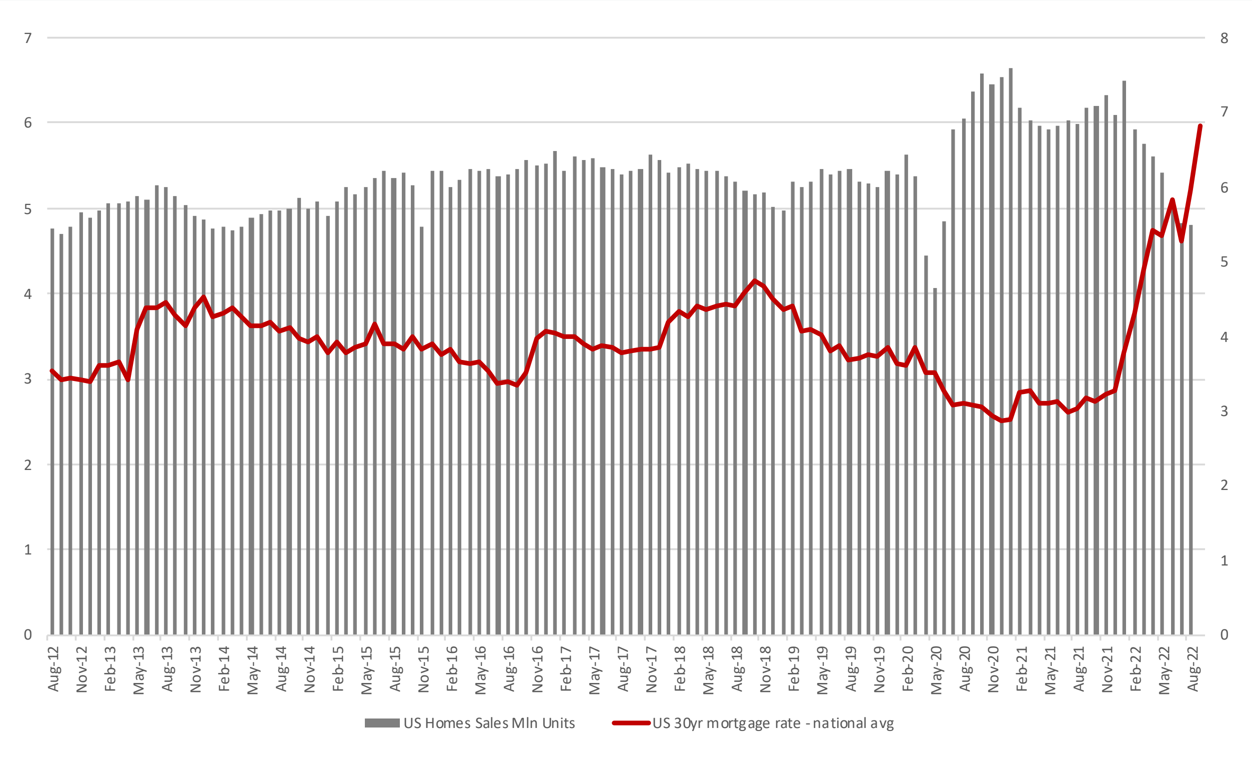
This is the dilemma facing the Eurozone, as the ECB is committed to raise its key interest rates in order to slow the economy and ultimately curb inflation. At the same time, most governments of the Euro zone are putting in place price curbs on energy prices and other support measures to mitigate the consequences of the energy crisis on households and small businesses. In this context, it is perhaps not so abnormal to see economic growth in the Euro zone outstrip that of the United States in the first half of the year, helped by rebounding services (post-covid), fiscal support (EU Next Gen plan) and exports' contribution... If there is one point on which the European interventionism cannot be criticized, it is the actions undertaken to reduce the EU dependence on Russian gas at an accelerated pace, whether by reducing consumption, diversifying its energetic mix and supplies, or storing natural gas at breakneck speed (already 88. 2% of storage capacity filled vs. 74.5% last year at the same time). While the risk of energy rationing remains elevated – and, by extension, the one of recession – the situation appears to be less catastrophic than initially feared when Russia invaded Ukraine in late Febrary.

The historical situation facing the United Kingdom is also tought to ignore. Faced with historic price pressures (9.9% increase in consumer prices), the Bank of England has no other option to embark on a rate hike cycle as soon as December 2021, without succeeding in curbing either inflation or the GBP depreciation. The massive debacle on the Pound and Gilts accelerated with the announcement by the new Truss government of GBP 145 billion in unfunded tax cuts and fiscal measures, letting no other option to the Bank of England than to intervene massively on the domestic bond market to prevent the collapse of pension funds.

Recession, a self-fulfilling prophecy?

The question we asked ourselves last quarter on the shift from a stagflation scenario to a recession one now seems to have been properly answered. While the U.S. labor market remains robust for now, the housing market is already showing signs of weakness as mortgage rates have doubled since the beginning of the year, prompting a 20% drop in home sales. Tighter financial conditions, as well as the collateral effects of a strong dollar, should also eventually act as a drag on economic activity. The prediction is becoming self-fulfilling and with two quarters already showing a contraction, we should already be in "technical" recession. In Europe, the risks are high but more binary: Yes, it will be difficult to escape recession if energy were to be rationed this winter, but the budgetary support remains stronger, the central bank more accommodating. The boost provided by a weak EUR is real, the region could enjoy the benefits of the "acquired" growth in Q1 and Q2.

G2: EXISTING HOME SALES IN MLN UNITS (LEFT SCALE) AND AVERAGE 30-YEAR MORTGAGE RATE (RIGHT SCALE)



Source: Banque Eric Sturdza, Bankrate, Bloomberg

While the debate between stagflation and recession scenarios is on the verge of being settled in favor of the latter, the question is now shifting to the level of inflation on which we should land, a level that will condition the change of attitude of the FED and the start of a new economic phase. The reflection must also include the recession pricing as not all assets started from the same point and did not integrate this scenario at the same pace... This is why we maintain a relatively cautious approach in our allocations at least in the short term.

3. FIXED INCOME
75BP OR NOTHING.

Fighting inflation at all costs

In September, the European Central Bank (ECB), the US Federal Reserve (Fed) and the Swiss National Bank (SNB) all raised their key interest rates by 75 basis points. They all used the same language, referring to inflation as a major threat to the economy that must be fought at all costs. In the US, if an aggressive monetary policy risks causing a recession with a deterioration of the labor market, the Fed will assume: the inflationary threat is greater than expected and in the coming months, it will not hesitate to raise its key rates in steps of +0.75% if necessary. The US inflation figures (excluding food and energy) show that a structural component has gradually been added to the cyclical component.

The Fed will try to start the year with key rates raised to 4.5% in order to take the time to analyze two elements that are essential for refining its monetary policy in 2023. These two subjects are the macroeconomic data (mainly growth and employment) and more particularly the speed of their deterioration, and secondly the first effects of the second pillar of its strategy, the reduction in size of its balance sheet, the famous Quantitative Tightening (QT).

US short rates already offer very good opportunities on the 2-3 year Investment Grade in US dollars above 4% in a "buy and watch" strategy.

Fixed Income strategy

In the very short term (one or two months depending on the turn of events), we favor the money market because credit spreads are still under pressure and long rates will have to digest the side effects of QT. As US short rates continue to rise, this already offers us some very good opportunities on the 2-3 year US dollar investment grade bonds that are now offering yields above 4% in a "buy and watch" strategy.

In our investment vehicles where we deploy a more active management strategy, we could also invest in very good quality credits at these levels or even above, as spreads have probably not finished their widening process.

On the long end of the curve (duration risk), the game seems more delicate and, in the end, the best strategy may be to wait and then bet on the highest point of the curve, probably the 5-year, at the moment when we are approaching the Fed's famous pivot rate. In the very short term, "cash is king" but we are ready to reinvest soon both on credits and on duration (10-30 years or 5 years rates depending on the curve deformation in October-November).

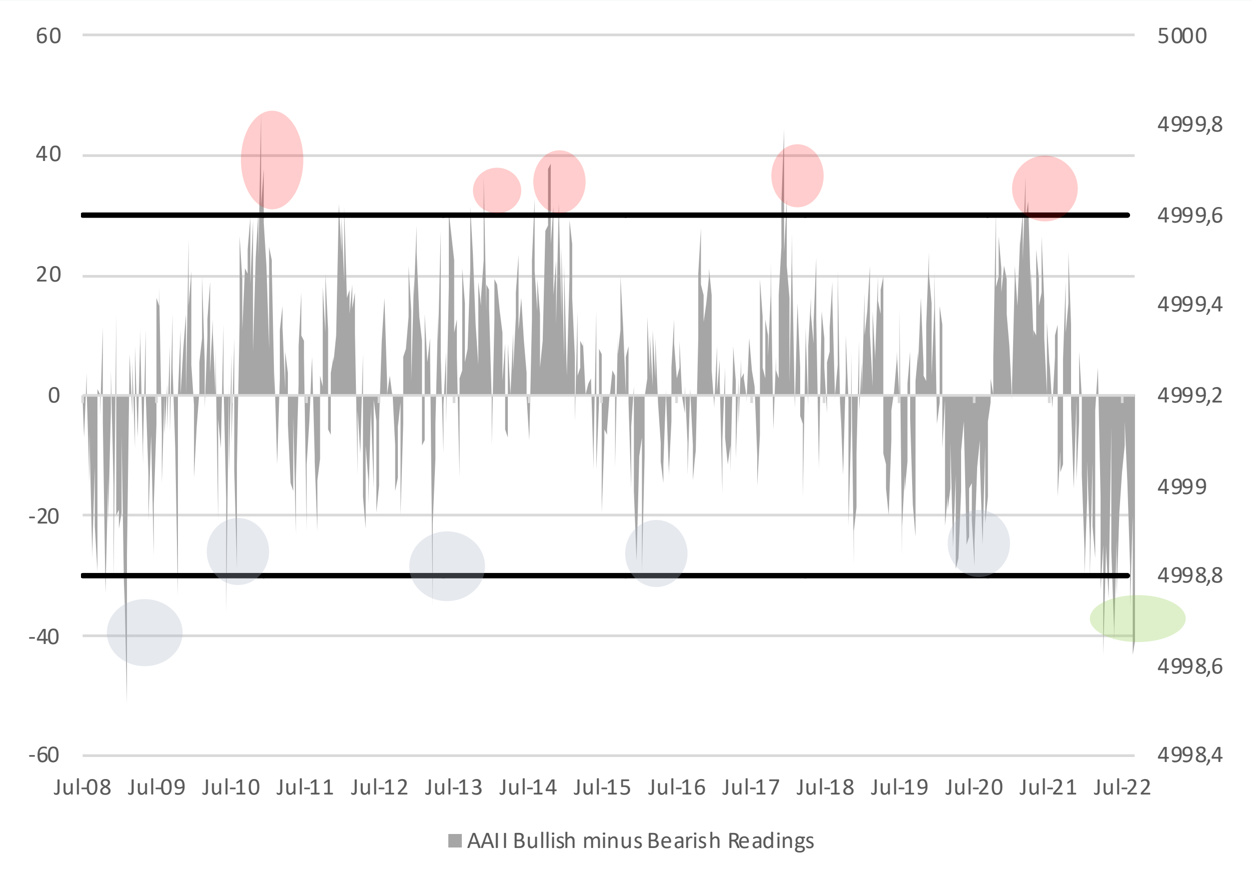
4. EQUITIES MARKETS

TOUGH BACK TO SCHOOL PERIOD.

After a summer during which investors were able to benefit from renewed optimism due to a radiant sunshine, very few travel restrictions, sound corporate results and the hope of a more accommodating Federal Reserve, the return to reality has been particularly hard. At the Jackson Hole symposium late August, Jerome Powell had warned that it was out of question for him to change his mind and that the soft landing scenario was to be forgotten.

It is therefore a very bloody month that we are ending on the equity markets. The decline for a world equity index is close to -10% and affects all equity markets without geographical and/or sectoral considerations. The Brazilian stock market, the IBOVESPA, is faring a little bit better but with the proximity of disputed national elections, it's probably dangerous to consider this situation as a given... In these conditions it is difficult to find an investor who is still bullish and the space is overcrowded by Bears. The AAII BULL-BEAR survey which probes the bullish or bearish sentiment of investors reflects this impressive turnaround: With 60% of the investors surveyed declaring themselves bearish, peak pessimism reached at the height of previous crises is exceeded.

G3: AAII INVESTOR SENTIMENT SURVEY
BULLISH INVESTORS - BEARISH INVESTORS



Source: Bloomberg, AAII, Banque Eric Sturdza

This contrarian indicator in itself could be one of the reasons not to despair completely as it has often been the prelude to sharp market reversals, but it must also be handled with caution as contrary to past occurences, the central bank is not on the side of investors and this indicator can prove little helpful with regards to the timing of such turnaround.

China continues to weigh on companies' sentiment and their growth prospects. The real estate crisis is real and is putting the government under pressure: for some this is "a serious problem but under Chinese authorities'control, for others this remains a "deep crisis". All in all, China is experiencing a severe slowdown, amplified by the "Zero Covid" policy which caused a major role in disrupting supply chains, well beyond China's borders. This situation is also exacerbated by the current standtill facing China in the wake of the upcoming Congress which should see Xi-Jinping reelected.

With an average price-to-earnings ratio for the Chinese market close to 11x, which is a significant discount to its own history and to that of the US market (S&P500 16.7x), the Chinese market is already integrating its quota of bad news. As the Party Congress is approaching, it should bring more visibility and possibly become the catalyst for more supportive actions from the Chinese authorities on the fiscal and monetary fronts.

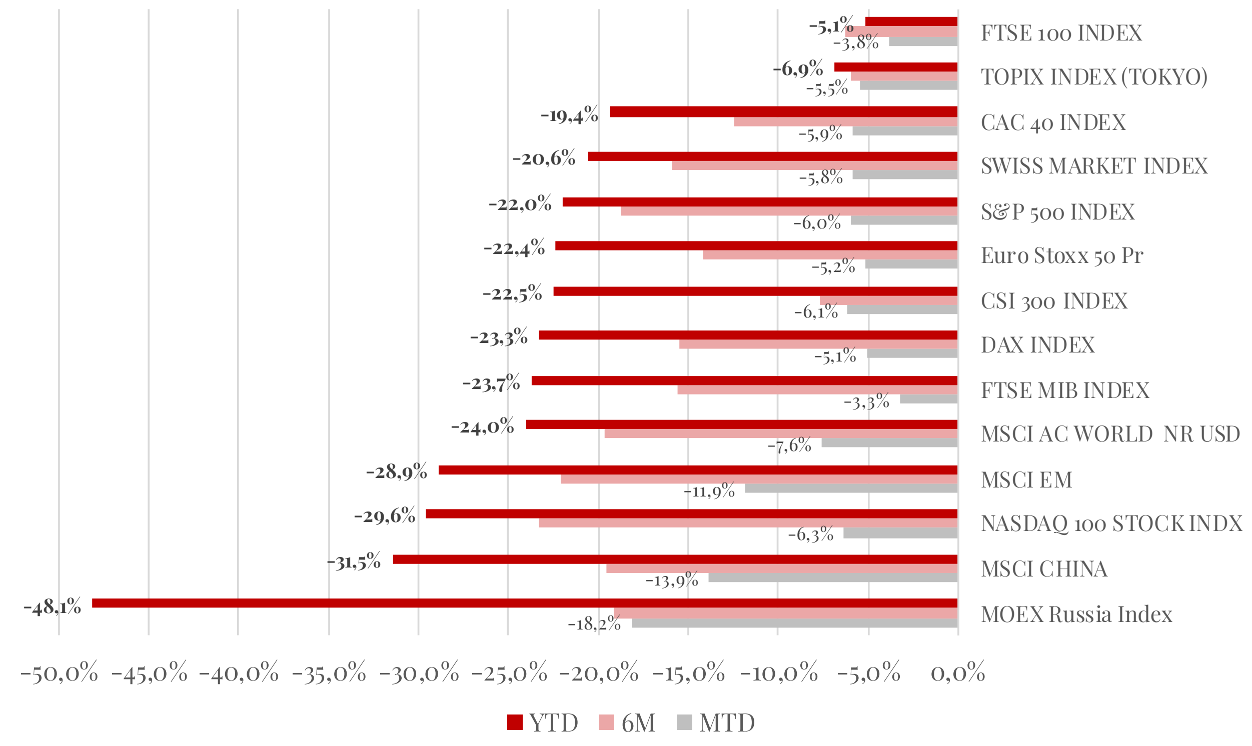
At the sector level, the health care and automotive sectors are holding up better. In a context marked by increased recessionary fears, the outperformance of the healthcare sector is hardly surprising. The one from the auto sector is much more intriguing, For sure, the sector is undoubtedly benefiting from the rebound of light vehicles'sales in Europe for the first time in 13 months (+3.4% in August), the very low valuation level reached by the sector and the renewed interest in the sector with the announcement of Porsche's IPO, the largest one by far this year.

Despite the decline in oil stocks over the month (a sector that had helped greatly Value until then), the Value style continues to hold up better against the large growth stocks. Thus, the Nasdaq 100, which had recovered more than 20% between June 15 and August 15, retraced all its gains with a very hawkish FED, and a disappointing Core CPI figure which confirmed J. Powell in his desire to continue to raise its key rates and to continue to reduce the FED's balance sheet.

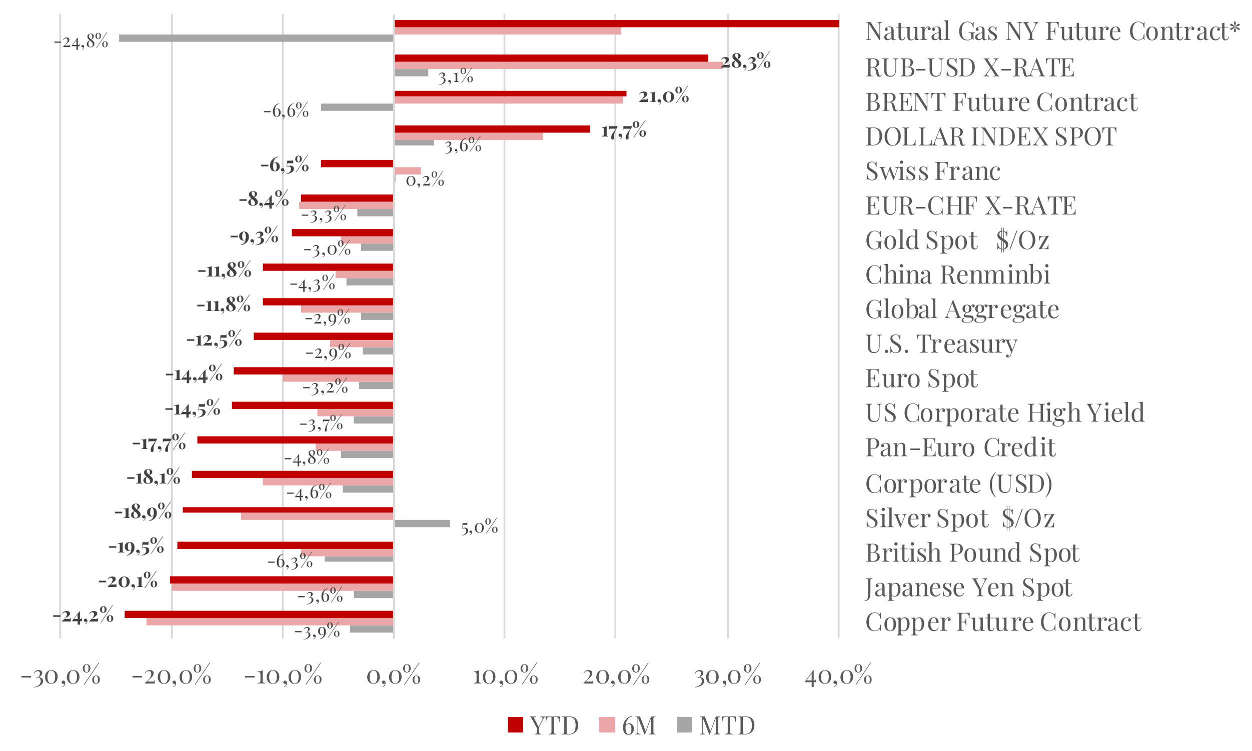
The performance of the equity market over the long term follows companies' earnings. While corporate earnings have been quite resilient in the face of declining stock prices, we remain particularly vigilant about which companies to hold in our portfolios, as the likelihood of downward earnings adjustment in a deteriorating environment seems high. Winter could bring its share of unpleasant surprises, which is why we continue to favor a cautious view of the equity markets, as well as asymmetrical approaches that allow participation while offering a certain degree of protection. In terms of typology, we continue to favor both quality growth stocks, which have undergone a significant derating and seem to be the best equipped to weather a more difficult environment, as well as some Value stocks on which the risk of a deterioration in the environment and earnings seems to be largely priced in.

6. PERFORMANCES

EQUITIES IN LOCAL CURRENCIES



FIXED INCOME, CURRENCIES AND COMMODITIES



Source : Bloomberg, Banque Eric Sturdza, 29/09/22

** 75 % YTD*

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Contributors

Marc Craquelin

Eric Vanraes

Pascal Perrone

Jeremy Dutoit

Edouard Bouhyer

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Contact

Banque Eric Sturdza SA

Edouard Bouhyer

invest@banque-es.ch

www.banque-es.ch