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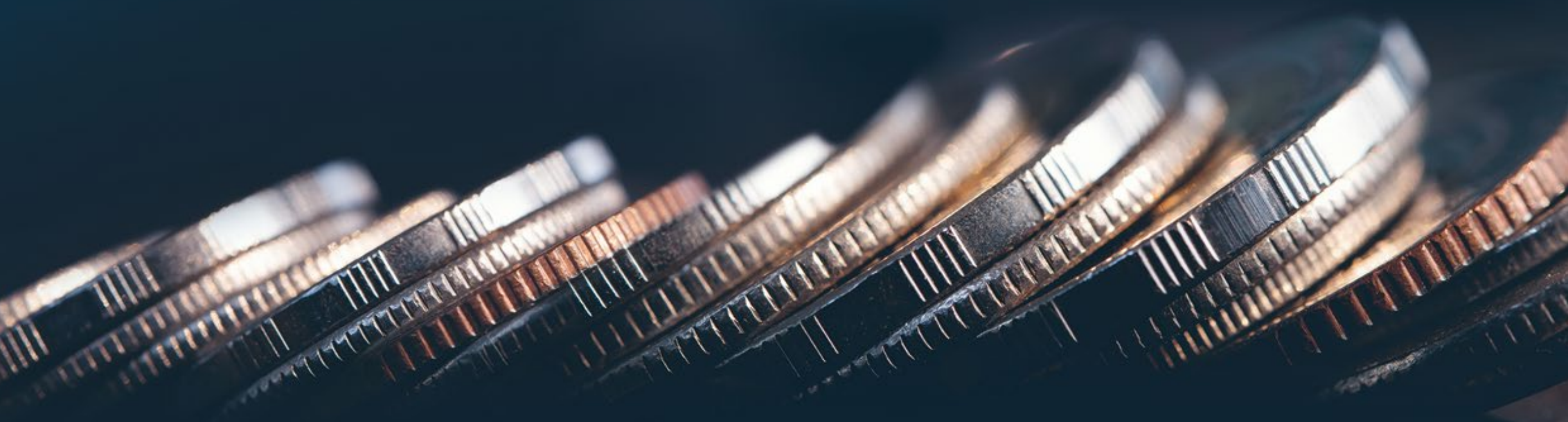

MONTHLY HOUSE VIEW

November 2022

The rate-hike poison: is the domino effect coming back?

Architects of Wealth

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01 • Editorial

THE RATE-HIKE POISON: IS THE DOMINO EFFECT COMING BACK?

"People only accept change when they are faced with necessity, and only recognise necessity when a crisis is upon them", Jean Monnet, Memoirs (1976).

Vincent MANUEL
Chief Investment Officer

Dear Reader,

An economic crisis can mask a financial crisis. While all eyes have been focused on the inflation trajectory and recession risk, the rise in rates seems to be acting like a slow and silent poison that continues to seep into financial players' balance sheets. That is, until the loud cracking sounds snap the central bankers back into their role of lender of last resort.

UK pension funds must have been relieved when the 30-year rate fell back down after the appointment of a new finance minister and the scrapping of the government's indefensible fiscal plan. But we came very close to a large-scale shock.

This scenario could have provoked a domino effect: hit with massive and intensifying margin calls, pension funds would have then found themselves with no liquidity, forcing them to sell a wide range of securities in a hurry. This is in part what happened. An interest rate shock was transformed into a financial panic, transmitting risk to market counterparties. To top it off, UK real estate funds would thus have been unable to meet redemption requests and would have suspended trading. This would have been the cocktail for a financial crisis that echoed the dynamic money market fund crisis of the summer of 2007.

What warning signs can we take from these recent events? First, the fact that every change of regime reveals the weaknesses of the previous regime. The last regime was characterised by the search for yield "at any cost" and the difficulty of accepting a downward adjustment to return expectations, in the face of low rates and zero inflation. The sharp rise in rates has wrong-footed all players that have accumulated significant leverage or rashly given up on liquidity.

Second, the fact that every market regime is also coupled with a school of thought and a belief system. One of the tightly held beliefs in the previous regime was the central banks' unwavering support of private-sector and government actors.

Another was the idea that the central banks made debt sustainable; debt in which institutional investors were forced to play an ongoing role. Yet central bankers remain focused on fighting inflation and, to retain their credibility (and that of their currency), they must not give in easily to governments that are tempted to wield fiscal leverage with the help of monetary policy. But macro-financial risks can quickly call this into question and jolt central banks back into their general firefighting role.

As a result, at the beginning of every financial crisis there is renewed hope that the monetary authorities will pick up the tab and that international institutions will nurse the most vulnerable back to health. That is the secret hope of the market: that the crisis will become so bad that the Federal Reserve (Fed) will be forced to pivot. This fails to take into account the stance of a central bank whose credibility is at stake, and which is all the more determined to keep full employment and inflation from weakening.

Every crisis has generally a capitulation phase that offers exceptional investment opportunities, when extreme pessimism leads to irrationally low valuations. We have maybe not yet reached this point, but it is likely imminent. One lesson learned from previous crises on this point is that they sometimes resemble seismic shocks, with repeated shocks and successive upheavals. 1992 before 1993. Mexico before Asia. Bear Stearns before Lehman. Exiting a crisis without purging or overhauling the system can prove to be short-lived.

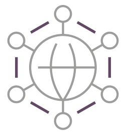
All this to suggest that it might be better to sell the relief rebound than to be too quick to believe in a year-end rebound that may not happen, despite the glaring opportunities. Resilience and patience have definitely been necessary throughout this very challenging year, but a very positive year for return assets could be on the horizon.

Enjoy your reading and I wish you all a wonderful autumn.

WILL BRAZIL ESCAPE THE GLOBAL MACROECONOMIC SLOWDOWN?

Adrien ROURE
Investment Strategy Analyst

As the IMF slashes growth across the globe, the institute has over the last six months raised Brazil's 2022 growth by a solid 2 percentage points to 2.8%. Next year, the Brazilian economy will undoubtedly decelerate. While this context, combined with the upcoming presidential elections, can provide noise in the short term, Brazilian assets can still offer investment opportunities especially in the fixed income universe.



BRAZIL remains very SENSITIVE to CHINESE ECONOMIC activity

THE BRAZILIAN ECONOMY HAS PERFORMED WELL...

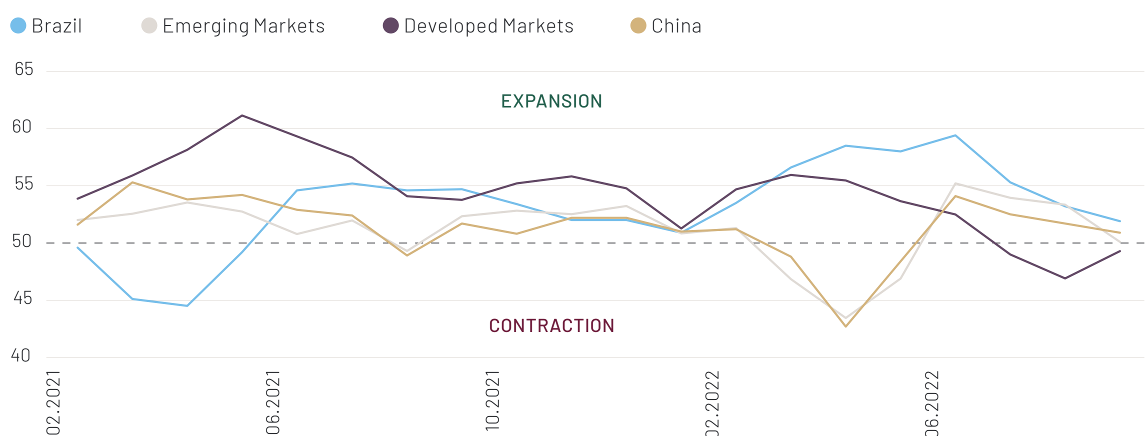
There are several factors that can explain the stunning performance of the Brazilian economy in the first half of 2022. The Brazilian economy is more insulated from the Western European geopolitical turmoil. Furthermore, as one of the top commodity exporters it has benefited from the rise in energy prices, namely oil, and agricultural products. Combined with favourable terms of trade, this has resulted in an increase in Brazil's trade balance while supporting a positive government primary balance[1] (approximately 2% of GDP in August) thanks to higher tax collections and oil royalties. Furthermore, household consumption, which accounts for over 60% of GDP, has held up well, propped up by the rising fiscal support of the Auxilio Brasil plan and tax cuts that provided protection to consumers against high inflation. The resilience of the labour market has been a supportive factor: job creation in services and construction has allowed unemployment to fall below 10% (the lowest level since January 2016).

...BUT WILL UNDOUBTEDLY JOIN THE GLOBAL SLOWDOWN

If the grass seems green, Brazil's recent leading economic indicators are pointing to a future slowdown in economic activity. The Composite PMI survey remains in expansionary territory (Chart 1), but has slowed from 59 in June to 52 in September. While it is difficult to envisage a total halt in fiscal support soon after the presidential election, demand is likely to slow. Households will be impacted by both the erosion of their precautionary savings and the rise in interest rates, forcing them to reduce their indebtedness, which reached its highest level in July at 53% of GDP.

The contribution of exports to growth will also decline. Although the share of exports in Brazil's GDP (20% of GDP) is lower than the global average (43%), the Brazilian economy remains sensitive to developments in world trade and in particular to Chinese economic activity, which alone accounts for one third of its exports.

CHART 1: AFTER A STUNNING H1 2022, LEADING ECONOMIC INDICATORS ARE SOFTENING, POINTS



Source: Bloomberg, Indosuez Wealth Management.

1 - Government balance excluding interest payments on public sector debt.

The China zero-COVID strategy and ongoing real estate downturn clearly constitute a downside risk for Brazil, as it reduces demand for industrial metals and oil. There are some supportive factors, however, the willingness of OPEC+ to set an implicit floor on oil prices should provide some support, while the country could also be seen as an alternative to Ukraine on the agricultural commodities front and allow China to reduce its dependence on the United States. As such, we forecast GDP growth to reach 1.4% next year.

BCB: A GLOBAL ROLE MODEL IN THE FIGHT AGAINST INFLATION?

The Brazilian YIELD CURVE offers ADVANTAGEOUS CARRY

Headline inflation in Brazil has peaked and is now at 7.2% year-on-year (YoY) (from its peak at 12% in April) while core inflation also started to decline from 9.7% three months ago to 8.6% in September. If those figures are still far from the central bank's target and also artificially deflated by tax cuts and subsidies, it has allowed the Banco Central do Brazil (BCB) to end the sharpest and most pre-emptive monetary rate hike cycle of any major economy.

The central bank should stay in a wait-and-see mode for some time, but the market has already started to price cuts next year with the 2-year bond rate retreating from 14% to 12.2% over the last quarter. Brazil has thus far been a role model in the management of inflation and its policy mix, as a Selic interest rate cut in 2023 would be timely in the context of a slowing economy and lower fiscal support.

WHAT ARE THE TAKE-AWAYS FOR INVESTORS?

Regarding upcoming elections, if left-wing candidate Lula da Silva - seen as the most likely to derail fiscal policy - came out on top, the legislative elections would likely strengthen the weight of the liberal and centrist's parties in parliament, reducing the risk of fiscal slippage as it would force him to make compromises.

Although the fiscal risk has been reduced, it has not disappeared, regardless the election outcome. Both candidates argue to reshape/remove the spending cap which limits public spending growth to the previous year's inflation. All in all, the debt-to-GDP ratio (from 90% at the peak of the pandemic to 77% today) could rise again.

Having these risks in mind, the Brazilian yield curve offers relative attractiveness: positive real rates, an advantageous carry with likely rate cuts to come, making Brazil one of the only countries where it is appealing to get duration. For USD investors, increasing exposure to local debt can also be an option to diversify their currency exposure and play a mean reversion of the greenback in 2023/2024 (although vulnerable to political risk and rate drops). Moreover, if Brazil's external debt is 40%, foreign ownership of government bonds is only 4%, limiting the risk of a major sell-off in case of foreign investor flight.

After a booming year with double-digit earnings growth, equity valuations look cheap, especially as analysts already anticipate an 11% earnings-per-share (EPS) drop next year. Brazilian equities represent an interesting value call should an investor want to hedge against a persistent stagflation scenario with elevated commodity prices. However, several risk factors need to be taken into account, both on the cyclical side (dependency to commodity outlook, most of the election outcome may already be priced), and the structural side (Brazil capacity to reform notably simplifying its complex fiscal framework).

GDP REVISED DOWN, INFLATION REVISED UP

Bénédicte KUKLA
Senior Investment Officer

It is clearly a difficult macroeconomic context where growth has been slashed almost universally, especially for 2023. Despite this cyclical downturn inflation persists. It is not all doom and gloom, as countries like Brazil and India have growth stories that have fared well, but world GDP growth will come in below 3% in 2023.

UNITED STATES
mortgage rates approaching
7%

US: SUBPAR GROWTH TO DAMPEN INFLATION

Despite two quarters of negative GDP growth, we expect a rebound in US Q3 2022 GDP driven by inventory volatility, a better trade balance and still resilient personal consumption spending foster by a still supportive jobs market, credit cards and savings. In 2023 these crutches will slowly be removed from US consumers. The real estate sector, a leading indicator of the US economic cycle, is beginning to feel the full effect of the Fed's interest rate hikes, with mortgage rates approaching 7%. Home sales are down 20% YoY and will continue to fall.

Encouragingly, inflation dropped for a second month in the US (to 8.2% YoY in September), but core inflation (excluding food and energy prices) increase (6.6% YoY), propped up by shelter prices.

While house prices only started to fall in June (down 21% YoY in July), their impact on the shelter price component of inflation is lagged by over a year. The "stickiness" of prices may explain in part the renewed increase in consumer 12-month inflation expectations in October. It is too early to eliminate a prolonged wage-price spiral, even if total inflation peaked in Q3. The US economy is heading towards prolonged sub-par growth (below 1% in 2023) which should help further moderate inflation, along with its energy autonomy and the continued unwinding in supply bottlenecks. Signs of weakness in the US jobs market have begun to emerge: the job openings to unemployed ratio - watched closely by the Fed to judge the tightness in the labour market - fell to 1.67 job openings per available worker. Wage growth may have peaked in September (to 6.3% YoY), but remains broad based in this still solid labour market.

EU: THE RISK OF THE UK EXPERIMENT LINGERS

In the Euro Area, industrial production came in above expectations (up 1.5% month-on-month (MoM) in August), thanks notably to some easing in supply constraints in the French and Spanish automobile sectors, putting upside risks on Q3 GDP along with a stellar tourism season. European headline inflation is now above the US (at 10.1% YoY), with core inflation (excluding food and energy prices) strengthening to 4.8% YoY. Producer prices are at 45% YoY in Euro Area (compared to 10% in US), putting corporates at a real competitive disadvantage, only slightly cushioned by EUR/USD weakness.

The energy crisis and policy coordination are the main risk factors for Europe. As the UK situation underlines, government shields can undermine central banks actions to combat inflation and the sustainability public debt ratios. In this light the new German fiscal shield was a bold move: 200 billion euros package (5% of GDP). Along with recent measures announced by the European Commission to cap gas and electricity prices, these fiscal measures put an upside on our below consensus forecasts in 2023 (Chart 2), as they will limit the impact of the energy crisis on purchasing power. However, the size of the German package highlights the unequal policy responses we can expect between wealthier and more debt ridden member states. Furthermore, the Euro Area is entering a long battle, with risks to secure energy supply now higher in winter 2023/2024 than 2022/2023.

EURO AREA
is entering a long
ENERGY BATTLE

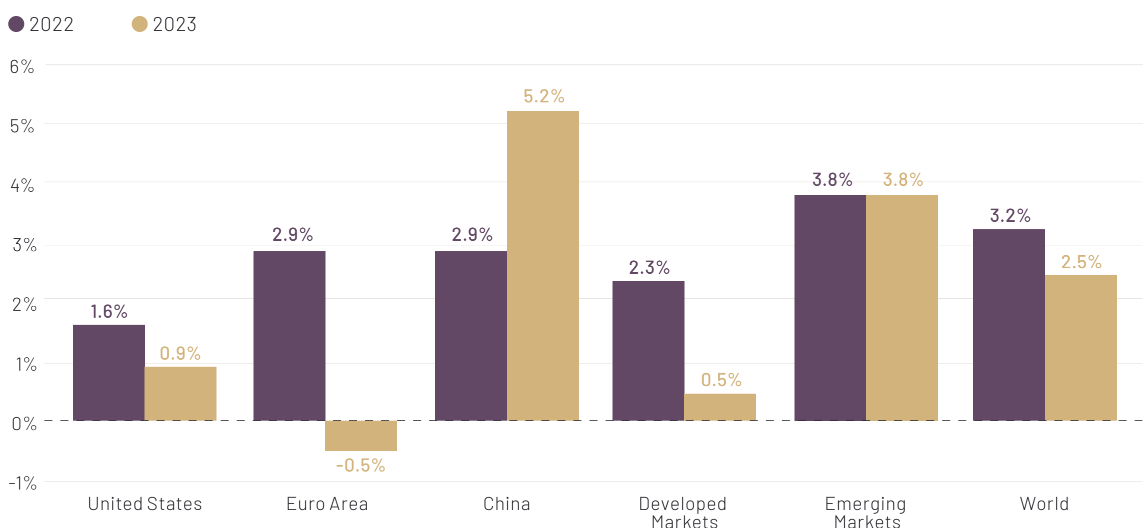
Finally, gas stock are currently 92% replenished, but dependency on US liquefied natural gas (LNG) supply (50% of total LNG imports in Q1), will be key going ahead and an element to watch after US mid-term elections in November.

CHINA: TAKING IT SLOW

The government has given no clear signal on loosening its zero-COVID policy that continues to paralyse the recovery. The debt deleveraging process - brought about by high corporate debt and the housing market downturn - is currently underway and further complicates the capacity of fiscal and monetary accommodative policies to increase consumption. Retail sales fell 0.5% MoM in August. Targeted measures to reassure households on the housing market have yet to bear fruit, while the delay in the release in Q3 GDP on week of the National Congress mid-October, has not helped market sentiment. Infrastructure investment should pick up more notably in Q4 and Q1 2023 as the recent measures fully materialise, but there is a lot of uncertainty in our growth scenario. Risks are skewed to the down side in the medium term, but in the coming weeks we could have some release in pent up demand in the case of unannounced policy change accelerating reopening.

All in all, world GDP growth will come in below 3% in 2023. In this context, food prices and metal prices are moderating, but oil prices are expected to remain high as OPEC reinforces supply cuts to maintain prices above USD 90 per barrel.

CHART 2: GDP GROWTH PROJECTION UPDATES FOR 2022 AND 2023, %



Source: Amundi, Indosuez Wealth Management.

UK PENSION FUND CRISIS: A NEW TEST FOR CENTRAL BANKS' CREDIBILITY

Thomas GIQUEL
Head of Fixed Income

With the contribution of the Fixed Income Team

The yield on the 30-year Gilt in the UK more than doubled in a couple of weeks, topping almost 5% by the end of September. This created a mini crisis on pension funds, which had to provide collateral for derivatives with counterparts, namely banks. The Bank of England intervened by the end of September, to prevent the pension fund crisis from spreading to the banking industry.

Orderly RISING RATES were easy to talk about...

...now LIQUIDITY is drying up even on the US TREASURY MARKET

CENTRAL BANKS AND CURVES

Central bankers are still on their course to over-tighten. Even though we could argue that tightening in front of slowing growth or even a recession is the recipe for disaster. Chairman Powell, Governor Bailey and European Central Bank (ECB) board member Schnabel seem convinced that a short term recession is better than a prolonged inflationary environment.

For now, the Fed benefits from unanimous hawkishness. As a result, multiple 75 bps hikes no longer come as a surprise, quantitative tightening is well underway and dollar liquidity is drying up, prompted also by the US treasury's financing needs (Chart 3). The consensus is more fragile in the governing council of the ECB. Hawks have the lead and are pushing for quantitative tightening in addition to raising rates to restrictive territory (approximately 2% disclosed vocally for the next two meetings and 3% next year). We should expect doves to start becoming more vocal going into year-end as growth decelerates.

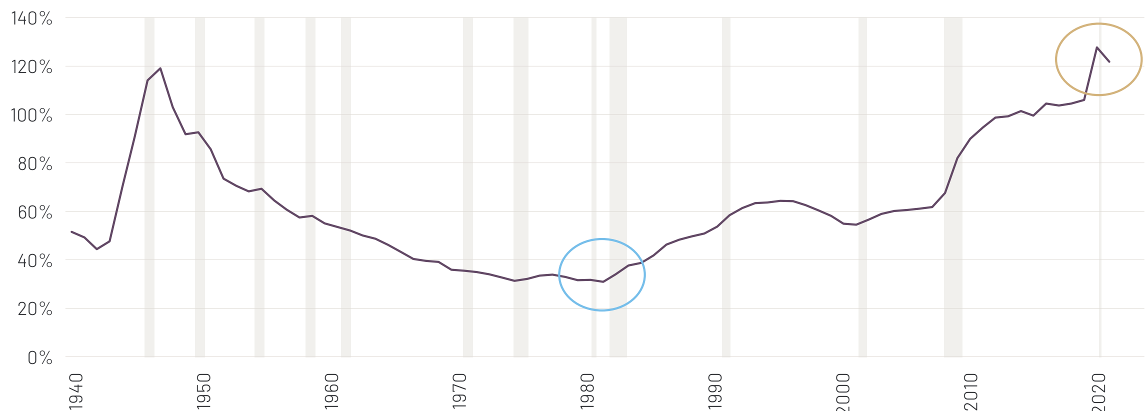
The Bank of England's (BoE) recent actions have been essential in order to keep central banks' credibility alive, on both rates and the currency. The BoE played its role of lender of last resort to prevent a vicious circle from forming in late September offering to buy unlimited amounts of Gilts for forced sellers. This was a way of cutting off the transmission of pension fund collateral needs to the banking system. The institution now confirms it will sell part of its bond portfolio starting 1 November.

Going forward, Fed funds will stay higher for longer and might pause higher. In the same timeframe, yield curves will be flatter and inverted for longer. In Europe, the ECB might also be tempted to hike aggressively, but we doubt it in the short term especially that the recent measures have pushed up Euro Area excess liquidity.

On the inflation front, while core and services inflation are still in an upward *momentum*, the headline may ease due to base effects. Market-wise, we believe inflation breakevens may be mispriced on the very short part of the curve, due to stickiness in many areas.

CHART 3: US FEDERAL DEBT/GDP RATIO

1980s: Volcker sharply increased real rates at a low point in the debt/GDP ratio
Today: Powell has to manage positive real rates at a high point in the debt/GDP ratio to curb inflation



Note: The Government needs nominal growth to i) reduce debt and ii) confront slowly eroding savings in order to avoid a saver's revolt!
Source: OMB, St. Louis Fed, Indosuez Wealth Management.

CREDIT MARKETS

Over time coupon levels will increase gradually. Considering maturity profiles for investment grade (IG) markets it will take several years before aggregate coupons reach pre-quantitative easing levels. At the spread level, IG bonds are trading above levels implied by rate volatility. They look attractive, but uncertainty prevails until year end, due to rates volatility and/or liquidity risks.

We still believe high yield (HY) markets are not in line with current volatility and technical factors (liquidity, cost of refinancing, idiosyncratic risks). On a fundamental basis, rating agencies have not yet reacted with overall outlooks being on the positive side. Investors need to look out for the re-appreciation of risk by agencies should soft data continue to deteriorate (PMI, consumer confidence, etc).

Subordinated debt is in the eye of a storm, as the market discounts a non-call exercise at the first call date. This creates opportunities on a name by name basis given that some issuers, already identified as investor friendly, are using different paths to pay-back, at least partially, investors. This segment obviously suffers from global dislocations, but could be a performance driver for next year.

BANKS FUNDAMENTALS ANALYSIS

As banks are at the forefront of risks, Indosuez credit analysts looked into the latest European Banking Authority (EBA) Quarterly Risk Dashboard[2], providing a consolidated picture of the EU banking system as of end-June 2022.

In summary, capital stays elevated (at 15%). There are early signs of deterioration in asset quality while liquidity buffers reflect ample liquidity. Last but not least, profitability is strong with return on equity (RoE) of 7.9% for Q2 (6.7% in Q1), driven by the increase in rates, controlled costs and lower impairments.

What to expect over the next 12-18 months? Slower growth in lending negatively affecting revenues, asset quality deterioration as corporate defaults increase and retail borrowers face higher cost of living. This will lead to an increase in provisioning, affecting the bottom line. Simultaneously, future funding conditions are expected to become more challenging, with an increase in wholesale funding costs, while the capital position should deteriorate slightly. We identify three lines of defence for bank bondholders:

- Earnings: pre-provision income will be supported by the higher-rate environment.
- Provisions: state loan loss allowances built-up during the COVID-19 crisis remain.
- Excess capital.

As markets are pricing an overly hawkish Fed going into 2023, we favour US 2-year bonds. In Europe, we stay cautious on rates as volatility clouds visibility. Nevertheless, short dated and high quality credit markets are a once in a decade opportunity with rates above 5% at the time of writing.

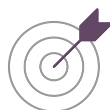
2 - https://www.eba.europa.eu/eba-risk-dashboard-shows-capital-ratios-remained-broadly-stable-and-liquidity-ratios-declined

AN UPCOMING EARNINGS SEASON IN THE SPOTLIGHT

Nicolas GAZIN
Global Head of Equity Solutions

Laura CORRIERAS
Equity Portfolio Manager

Central bank policies remain the main concern for investors, notably with the latest strong macroeconomic fundamentals which take away the hope of a rapid end to the Fed's tightening cycle. On the micro side, earnings revisions have started to turn down. Nevertheless, we believe that the upcoming season could be better than feared given notably the good corporate pre-announcement ratios.



EPS GROWTH EXPECTED AT **+8.4%** for 2022 and **+6%** for 2023

EARNINGS SEASON

The earnings season is expected with a lot of nervousness from investors. Earnings expectations remain resilient with EPS growth expected at +8.4% for 2022 and +6% for 2023 for the MSCI World. But getting closer to the end of the 2022 year, we are now seeing downward revisions regarding EPS growth 3-month change for 2023, notably from the US side which shows a -3.6% decline for the MSCI USA. On the Asian front (ex. Japan) this decrease has reached -10.5% for 2023. However, for Europe and UK, EPS growth has been more resilient solely due to the positive currency effect.

The earnings season for Q3 2022 will provide more information about the ability of companies to maintain their margins in a context of high inflation, concerns about commodities prices and labour costs; forecast guidance will be further scrutinised. We believe that it could turn out to be less bad than expected, judging from the pre-announcement ratio of companies that have been very strong overall (Chart 4).

UNITED STATES

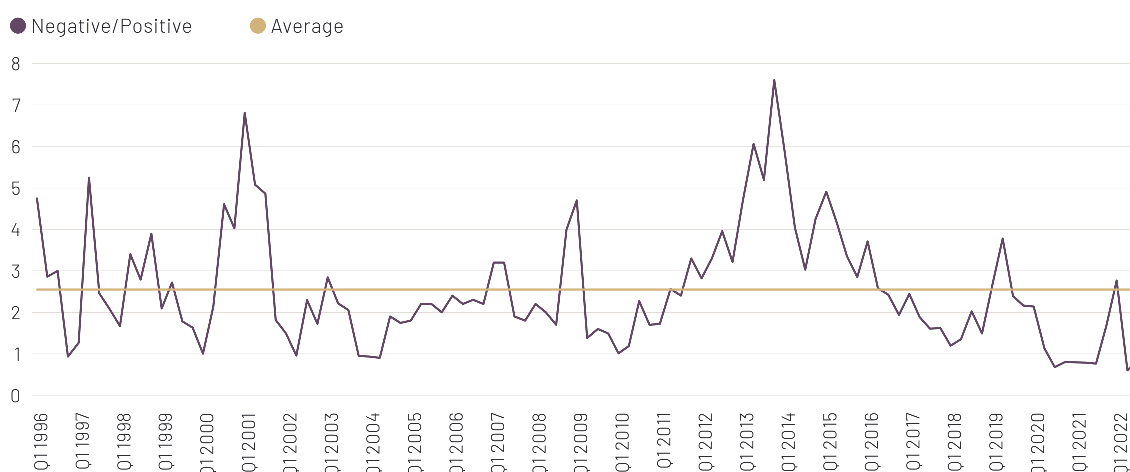
Equity markets in the United States remain focused on the Fed's decisions and the evolution of real yields. In this context of concerns, the market is trading at relative price-to-sales (P/S) lows on some sectors, such as technology.

In a microeconomic view, US companies are facing headwinds: on the one hand, most commodity prices have fallen over the past six months in dollar terms and, on the other hand, exporting companies, with a significant portion of their sales abroad, could be impacted from the strengthening of the dollar against other currencies. Domestic demand is expected to weaken in light of consumer negative purchasing power.

In this uncertain context, investors are particularly pessimistic, as is the case with the Bull-Bear Index, which is at its lowest level since February 2009, close to the low points of the 2007-2009 financial crisis.

This very negative investor sentiment coupled with a rather favourable seasonality (especially as we are in a mid-term election year) could be conducive to a bear market rally.

CHART 4: S&P 500 NEGATIVE-TO-POSITIVE PRE-ANNOUNCEMENT RATIO



The SPX Negative/Positive pre-announcement ratio (corporate sources) is at its lowest levels which is very positive; that means there are more positive revisions relative to downward revisions.
Source: Citi Group, Indosuez Wealth Management.

EUROPE

Some good news on European energy side: gas capacities in Europe were fully replenished for upcoming winter and the US put some more oil from their strategic reserves on the market which relaxed energy prices.

The Euro Area market is still trading at a record discount to the US notably. Investors have already priced a significant slowdown that does not appear in company figures. We could therefore experience some kind of bear market rally, but once again fundamentals appear unchanged and call for a still cautious stance.

Moreover, the sentiment of investors remains bearish notably due to the shadow of geopolitics in Europe.

The situation in the UK is particularly worrying: interest rates at these levels are going to impose acute pain across the household sector, predominately through mortgages, and also into the corporate sector via bond yields and bank lending rates. Inflation is at its highest rate and there are some concerns about a domestic policy slippage.

EMERGING MARKETS

The Chinese Communist Party (CCP) Congress (now in progress at the time of writing) has been quite neutral overall, so far, with some positive (on economic development and globalisation/multilateralism), some neutral (COVID-19 policy, Taiwan issue) and some negative (heightened focus on national security). However, some gradual relaxation of COVID-19 measures and continued support to the economy could be in the cards over the next few months.

Selected Asia equity valuations are now attractive, but earnings *momentum* still has to improve and global sentiment remains negative towards Emerging Markets (EM). We favour a two-pronged approach in terms of country allocation with positive views on China as well as Indonesia, India and Australia while being neutral South Korea and Philippines and underweight Taiwan and the rest of ASEAN. See Focus on the Latam region (page 4).

INVESTMENT STYLE

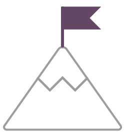
Rising real yields have continued to push for a derating for highly valuated quality stocks. At the same time, we think the next earnings season will be focused on pricing power and margins which should support quality stocks notably in the current context of high market volatility. The game changer for this style will be the pivot on long term rates. With the US 10-year yield close to 4%, we believe a large part of this headwind is behind us. It is too early to come back to the high growth style. We prefer to keep quality (at reasonable price, QARP) and return to shareholders as our favourite styles. As long as interest rates are orientated on the upside, we keep an opportunistic value exposure, notably on energy. Moreover, the value versus growth stocks are still trading at a historical discount level. According to our investment clock, the value style remains a bet to play in phases of economic slowdown with high inflation.

TURBULENCE IN THE FOREX MARKET

Muriel ABOUD SCHIRMANN
Head of Capital Markets Advisory

Davis HALL
Head of Capital Markets, Asia

The month of October was marked by the panic caused by the announcement of the UK budget with the pound sterling being the most volatile currency. All eyes are still focused on: double digit inflation, the energy crisis that weakens the trade balances in many countries, US monetary normalisation and the strong divergence between central banks increasing tensions on exchange rates (Chart 5).



VOLATILITY in the forex market surges to HIGHEST levels SINCE 2020

USD

No courage to fight the Fed

Market participants have succumbed to the green-back's *momentum* despite ballooning twin deficits. The neglected macro backdrop is thus far from rosy as recessionary warnings abound into 2023 as FOMC hawkishness persists. With distant hopes for a Powell-pivot evaporated for 2022 – it's now entirely down to the appeal of ever rising rates and relative yield spreads versus peers. This effective USD 'scarcity margin call' scenario may well persist into illiquid year end; until other central bank's catch up in lead-lag hiking mode. Until then, it takes immense courage to countertrade the high yielding USD.

EUR

No news good news?

Euro was relatively stable in October as the strength of the US dollar took a break. With Europe's energy crisis still unresolved and the war between Ukraine and Russia still raging in the East, there is no reason at this point to believe that the downward trend against the dollar should stop. From a technical perspective, the correction we have seen from the late September lows until today may continue, but the euro will need new catalysts to get back above parity. The focus remains on the upcoming ECB meeting, where the council will likely discuss the start of the quantitative tightening.

CHART 5: CURRENCY VOLATILITY INDEX, CVIX

Source: Bloomberg, Indosuez Wealth Management.

GBP

UK Government Crisis

The past few weeks have been extremely volatile for the sterling pound. After hitting a low at 1.0350 against US dollar on 26 September, we saw the currency pair rally 11% to 1.1495 in early October. After several weeks of political turmoil, Jeremy Hunt was appointed Chancellor of the Exchequer by Liz Truss, following the dismissal of Kwasi Kwarteng. Hunt cancelled most of the stimulus measures planned by his ousted predecessor. His new program is much more consistent with BoE monetary tightening. The pound sterling has been positively impacted in the short term. However, structural weaknesses remain with high inflation, higher US yields and the European energy crisis. Moreover, investors will have to regain confidence in the government before they see some stability in the currency and this may take some time. Thus, pound sterling should continue to be under pressure at least until the end of the year.

CHF

Surprise SNB liquidity request extended

The Swiss franc has remained largely range bound versus peers. However, in a rare sign of market stress the Swiss National Bank (SNB) had to tap their standing cross currency swap line with the Fed. Often seen as a proxy to rising liquidity tensions, they tapped some USD 6 billion in weekly funding needs at 3.33%. Local Swiss banks are seen to be building cash collateral buffers ahead of the critical year-end scramble for dollars – yet another indication that the greenback's effective 'margin call' versus all forex pairs is still underway. We like to hold safe haven CHF in portfolios, with best safe haven fundamentals.

JPY

Kuroda digs in deeper

Persistent Japanese yen underperformance appears somewhat 'tolerated' by the Bank of Japan (BoJ) despite unilateral forex market intervention. So far the yen weakening trend has not been turned – merely smoothed by muted JPY purchases. Authorities have had no other choice than to join the Asian bandwagon of central banks weighing in versus the US dollar to support their currencies and arrest imported inflation.

The BoJ Governor Haruhiko Kuroda may well be in his final mandate months, yet seems stubbornly committed to his Japanese Government Bonds (JGB) purchases and yield curve control measures. Until JGB yields are allowed to return to their true market levels, the interest rate differentials will see the yen suffer still.

AUD

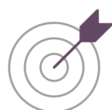
Fragile tightrope act for the RBA

The Royal Bank of Australia disappointed market expectations for another hawkish hike and under-delivered. Clearly, they must quell imported inflation but equally address the domestic housing bubble and homeowner base largely subjected to rapidly rising variable borrowing rates. Furthermore, renewed slowdown fears in China and maintained zero-COVID policies fail to dent the deepening pessimism related to any resurgent demand from their key trading partner. As such, the AUD has been unable to benefit from its 're-opening' status as the US dollar simply grinds higher versus all. We maintain a constructive medium term view for the Australian dollar, however deeper base building is required to attract diversification inflows.

07 • Asset Allocation

INVESTMENT SCENARIO AND ALLOCATION CONVICTIONS

Vincent MANUEL
Chief Investment Officer



2023 inflation
4%
in the US and
6%
in the Euro Area

INVESTMENT SCENARIO

- **Growth:** recession in 2023 in Europe, stagnation in the US with very moderate growth; stronger growth in emerging countries, but risk surrounding a Chinese recovery macro policy in a deleveraging context and liquidity trap risk.
- **Inflation:** world inflation will still remain around 5% in 2023 (4% in the US and 6% in the Euro Area).
- **Fiscal policy:** very supportive from a cyclical and social standpoint, but increasing risks from a debt sustainability standpoint.
- **Central banks:** focused on inflation unless a stronger than expected recession risk or financial turmoil disrupts their tightening agenda. Policy divergence dominates contributing to forex market volatility.
- **Earnings:** as no previous downturns have occurred without a form of earnings contraction, we see the consensus as an optimist laggard, and we rather anticipate at least a 5% EPS contraction next year in developed markets.
- **Volatility:** as expected, volatility rose this autumn after the summer rally and is now affecting all asset classes, with limited diversification areas, but reaching levels that start to offer attractive investment opportunities in optional strategies.

ALLOCATION CONVICTIONS

EQUITIES

- We keep a preference for US equities and global thematics, as we continue to see Europe as the most vulnerable region in the context of this energy tapering.
- However we acknowledge that European equities' discount to their US peers has reached a record level and that European exporters should benefit from a strong USD.
- Therefore we adopt a less negative view on Europe and also take into account pre-emptive measures that could help limiting the negative hit from energy rationing and placing an upside risk on our growth scenario.
- Within emerging markets, we continue to prefer Asian equities and underline the very discounted valuation metrics of Chinese equities but recognise that visibility remains very limited; diversification towards broader EMS can be justified in this context.
- From a sector and style perspective we continue to express our preference for a balance between quality companies, cash and dividend generative models and value stocks benefiting from this reflation environment.

FIXED INCOME

- We keep the view adopted in the past two months on government bonds, with a barbell between very short maturities (which integrate well the upcoming rate hikes) and the ultra-long part of the curve (which could act as a macro hedge as recession looms).
- We continue to favour investment grade over high yield bonds that have relatively unattractive spreads compared to investment grade bonds.
- We, however, keep a relatively constructive view on financial debt as we see financials' balance sheets relatively solid and see more risk on leveraged industrial companies.
- We remain relatively cautious on emerging debt in hard currencies and acknowledge that local currency bonds represented an interesting diversification in 2023 for EUR investors despite the stronger volatility it generates.

FOREX MARKETS

- We see the US dollar as rich and already pricing the long list of reasons explaining its strength: higher interest rates, better macroeconomic situation, a more credible Fed, less political risk and a costly hedge.
- However, we see limited reasons that could lead other currencies to bounce back against the greenback in the very short term, given the level of macro and policy uncertainty around the globe and the weakening current accounts of Europe due to energy prices. We also highlight the policy divergence that could lead main Asian currencies such as yen and CNY to stay relatively weak against the dollar.
- Liquidity stress surrounding the UK situation also contributed to USD strength.
- This dollar dominance is set to change when the Fed will soften its stance, or if the risks surrounding the Euro Area and the UK were to diminish.
- Meanwhile we continue to see commodity currencies as good diversifiers for USD investors, and CHF as the best hedge outside the dollar, notably for EUR investors.

KEY CONVICTIONS

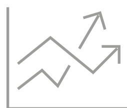
	TACTICAL VIEW (ST)	STRATEGIC VIEW (LT)
FIXED INCOME		
GOVERNMENTS		
Core EUR 10-Year (Bund)	=/-	=
EUR Periphery	-	=/-
US 2-Year	=/+	=/+
US 10-Year	=/-	=
US 30-Year	=/+	=/+
EUR Breakevens Inflation	=	=
US Breakevens Inflation	=	=
CREDITS		
Investment grade EUR	=/+	+
High yield EUR/BB- and >	=/-	=
High yield EUR/B+ and <	=/-	=/-
Financials Bonds EUR	=	=
Investment grade USD	=/+	+
High yield USD/BB- and >	=/-	=
High yield USD/B+ and <	=/-	=/-
EMERGING DEBT		
Sovereign Debt Hard Currency	=/-	=/+
Sovereign Debt Local Currency	=	=/+
Latam Credit USD	=	=
Asia Credit USD	=/-	=
Chinese Bonds CNY	=/-	=
EQUITIES		
GEOGRAPHIES		
Europe	=	=
United States	=	=/+
Japan	-	=/-
Latin America	=/-	=
Asia ex-Japan	=	=
China	=	=
STYLES		
Growth	=/-	+
Value	=/-	=
Quality	+	=/+
Yield	+	=/+
Cyclical	-	=
Defensive	+	=/-
FOREX		
United States (USD)	=	=/-
Euro Area (EUR)	=/-	=
United Kingdom (GBP)	=/-	=
Switzerland (CHF)	=/+	=
Japan (JPY)	=	=/-
Brazil (BRL)	=	=
China (CNY)	=	=
Gold (XAU)	=	=
Commodity currencies (NOK, NZD, CAD)	=/+	=/+

Source: Indosuez Wealth Management.

08 • Market Monitor (local currencies)

OVERVIEW OF SELECTED MARKETS

DATA AS OF 20 OCTOBER 2022



GOVERNMENT BONDS	YIELD	4 WEEKS CHANGE (BPS)	YTD CHANGE (BPS)
US Treasury 10-year	4.23%	51.45	271.82
France 10-year	2.96%	43.70	276.10
Germany 10-year	2.40%	43.80	258.10
Spain 10-year	3.53%	44.90	296.30
Switzerland 10-year	1.34%	-0.80	147.60
Japan 10-year	0.25%	2.00	18.50

BONDS	LAST	4 WEEKS CHANGE	YTD CHANGE
Governments Bonds Emerging Markets	32.04	-3.90%	-18.31%
Euro Governments Bonds	193.63	-1.40%	-11.40%
Corporate EUR high yield	184.67	-2.20%	-13.56%
Corporate USD high yield	286.91	-1.23%	-13.69%
US Government Bonds	288.67	-1.63%	-9.87%
Corporate Emerging Markets	40.15	-4.93%	-21.27%

CURRENCIES	LAST SPOT	4 WEEKS CHANGE	YTD CHANGE
EUR/CHF	0.9820	2.17%	-5.36%
GBP/USD	1.1235	-0.23%	-16.97%
USD/CHF	1.0037	2.61%	9.95%
EUR/USD	0.9786	-0.51%	-13.93%
USD/JPY	150.15	5.45%	30.47%

VOLATILITY INDEX	LAST	4 WEEKS CHANGE (POINTS)	YTD CHANGE (POINTS)
VIX	29.98	2.63	12.76

EQUITY INDICES	LAST PRICE	4 WEEKS CHANGE	YTD CHANGE
S&P 500 (United States)	3'665.78	-2.45%	-23.09%
FTSE 100 (United Kingdom)	6'943.91	-3.01%	-5.97%
STOXX 600	398.77	-0.25%	-18.25%
Topix	1'895.41	-1.08%	-4.86%
MSCI World	2'429.26	-2.41%	-24.83%
Shanghai SE Composite	3'754.93	-2.96%	-23.99%
MSCI Emerging Markets	864.76	-6.27%	-29.81%
MSCI Latam (Latin America)	2'229.21	1.55%	4.66%
MSCI EMEA (Europe. Middle East. Africa)	189.62	1.23%	-31.22%
MSCI Asia Ex Japan	539.53	-8.41%	-31.64%
CAC 40 (France)	6'086.90	2.85%	-14.90%
DAX (Germany)	12'767.41	1.88%	-19.63%
MIB (Italy)	21'701.50	-0.45%	-20.64%
IBEX (Spain)	7'644.40	-1.68%	-12.27%
SMI (Switzerland)	10'473.45	1.71%	-18.66%

COMMODITIES	LAST PRICE	4 WEEKS CHANGE	YTD CHANGE
Steel Rebar (CNY/Tonne)	3'696.00	-5.42%	-18.73%
Gold (USD/Oz)	1'628.02	-2.58%	-11.00%
Crude Oil WTI (USD/Bbl)	85.98	2.98%	14.32%
Silver (USD/Oz)	18.69	-4.39%	-19.97%
Copper (USD/Tonne)	7560.5	-1.56%	-22.22%
Natural Gas (USD/MMBtu)	5.36	-24.42%	43.65%

Source: Bloomberg, Indosuez Wealth Management.
Past performance does not guarantee future performance.

MONTHLY INVESTMENT RETURNS, PRICE INDEX

FTSE 100 · Topix · MSCI World · MSCI EMEA · MSCI Emerging Markets
STOXX 600 · S&P 500 · Shanghai SE Composite · MSCI Latam · MSCI Asia Ex Japan

BEST PERFORMING (+)

JULY 2022	AUGUST 2022	SEPTEMBER 2022	4 WEEKS CHANGE	YTD (20.10.2022)
9.11%	1.18%	-3.37%	1.55%	4.66%
7.86%	0.03%	-5.36%	1.23%	-4.86%
7.64%	-0.04%	-6.48%	-0.25%	-5.97%
4.22%	-0.22%	-6.57%	-1.08%	-18.25%
3.71%	-1.04%	-6.72%	-2.41%	-23.09%
3.54%	-1.88%	-8.19%	-2.45%	-23.99%
3.18%	-2.19%	-9.34%	-2.96%	-24.83%
-0.69%	-4.24%	-9.46%	-3.01%	-29.81%
-1.66%	-4.33%	-11.90%	-6.27%	-31.22%
-7.02%	-5.29%	-12.94%	-8.41%	-31.64%

(−) WORST PERFORMING

Source: Bloomberg, Indosuez Wealth Management.
Past performance does not guarantee future performance.

Basis point (bp): 1 basis point = 0.01%.

Blockchain: A technology for storing and transmitting information. It takes the form of a database which has the particularity of being shared simultaneously with all its users and generally does not depend on any central body.

BLS: Bureau of Labor Statistics.

BNEF: Bloomberg New Energy Finance.

Brent: A type of sweet crude oil, often used as a benchmark for the price of crude oil in Europe.

CPI (Consumer Price Index): The CPI estimates the general price level faced by a typical household based on an average consumption basket of goods and services. The CPI tends to be the most commonly used measure of price inflation.

Cyclicals: Cyclicals refers to companies that are dependent on the changes in the overall economy. These stocks represent the companies whose profit is higher when the economy is prospering.

Defensives: Defensives refers to companies that are more or less immune to the changes in the economic conditions.

Deflation: Deflation is the opposite of inflation. Contrary to inflation, it is characterised by a sustained decrease in general price levels over an extended period.

Duration: Reflects the sensitivity of a bond or bond fund to changes in interest rates. This value is expressed in years. The longer the duration of a bond, the more sensitive its price is to interest rate changes.

EBIT (Earnings Before Interest and Taxes): Refers to earnings generated before any financial interest and taxes are taken into account. It takes earnings and subtracts operating expenses and thus also corresponds to non-operating expenses.

EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortisation): EBITDA takes net income and adds interest, taxes, depreciation and amortisation expenses back to it. It is used to measure a company's operating profitability before non-operating expenses and non-cash charges.

ECB: The European Central Bank, which governs the euro and Euro Area member countries' monetary policy.

Economic Surprises Index: Measures the degree of variation in macro-economic data published versus forecasters' expectations.

Economies of scale: Decrease in a product's unit cost that a company obtains by increasing the quantity of its production.

EPS: Earnings per share.

ESG: Non-financial corporate rating system based on environmental, social and governance criteria. It is used to evaluate the sustainability and ethical impact of an investment in a company.

Fed: The US Federal Reserve, i.e. the central bank of the United States.

FOMC (Federal Open Market Committee): The US Federal Reserve's monetary policy body.

GDP (Gross Domestic Product): GDP measures a country's yearly production of goods and services by operators residing within the national territory.

Gig economy: system characterised by flexible, temporary or freelance jobs.

Growth: Growth style refers to companies expected to grow sales and earnings at a faster rate than the market average. As such, growth stocks are generally characterised by a higher valuation than the market as a whole.

IEA: International Energy Agency.

IMF: The International Monetary Fund.

Inflation breakeven: Level of inflation where nominal bonds have the same return as inflation-linked bonds (of the same maturity and grade). In other words, it is the level of inflation at which it makes no difference if an investor owns a nominal bond or an inflation-linked bond. It therefore represents inflation expectations in a geographic region for a specific maturity.

Inflation swap rate 5-Year, 5-Year: A market measure of what 5-Year inflation expectations will be in five years' time. It provides a window into how inflation expectations may change in the future.

IPPC: The Intergovernmental Panel on Climate Change.

IRENA: International Renewable Energy Agency.

ISM: Institute for Supply Management.

Japanification of the economy: Refers to the stagnation the Japanese economy has faced in the last three decades, and is generally used to refer to economists' fears that other developed countries will follow suit.

Metaverse: A metaverse (portmanteau of meta and universe) is a fictional virtual world. The term is regularly used to describe a future version of the internet where virtual, persistent and shared spaces are accessible via 3D interaction.

OECD: Organisation for Economic Co-operation and Development.

Oligopoly: An oligopoly occurs when there is a small number of producers (supply) with a certain amount of market power and a large number of customers (demand) on a market.

OPEC: Organization of the Petroleum Exporting Countries; 14 members.

OPEC+: OPEC plus 10 additional countries, notably Russia, Mexico, and Kazakhstan.

PMI: Purchasing Managers' Index.

Policy mix: The economic strategy adopted by a state depending on the economic environment and its objectives, mainly consisting of a combination of monetary and fiscal policy.

Pricing power: Refers to the ability of a company or brand to increase its prices without affecting demand for its products.

Quality: Quality stocks refers to companies with higher and more reliable profits, low debt and other measures of stable earnings and strong governance. Common characteristics of Quality stocks are high return to equity, debt to equity and earnings variability.

Quantitative easing (QE): A monetary policy tool by which the central bank acquires assets such as bonds, in order to inject liquidity into the economy.

SEC (Securities and Exchange Commission): The SEC is an independent federal agency with responsibility for the orderly functioning of US securities markets.

Spread (or credit spread): A spread is the difference between two assets, typically between interest rates, such as those of corporate bonds over a government bond.

Secular stagnation: Refers to an extended period of little or no economic growth.

SRI: Sustainable and Responsible Investments.

Stagflation: Stagflation refers to an economy that is experiencing simultaneously an increase in inflation and stagnation of economic output.

TPI : An addition to the Eurosystem's toolkit that can be activated by the ECB to counter unwarranted, disorderly market developments if these pose a serious threat to the smooth transmission of monetary policy across the euro area. The ECB Governing Council approved the instrument on the 21 July 2022.

Uberisation: Term derived from the name of US company Uber which develops and operates digital platforms that connect drivers and riders. It refers to a new business model that leverages new digital technologies and is part of the sharing economy, insofar as it puts customers in direct contact with service providers, at a reduced cost and with lower prices.

Value: Value style refers to companies that appear to trade at a lower price relative to its fundamentals. Common characteristics of value stocks include high dividend yield, low price-to-book ratio, and a low price-to-earnings ratio.

VIX: The index of implied volatility in the S&P 500 Index. It measures market operators' expectations of 30-day volatility, based on index options.

WTI (West Texas Intermediate): Along with Brent crude, the WTI is a benchmark for crude oil prices. WTI crude is produced in America and is a blend of several sweet crude oils.

WTO: World Trade Organization.

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