Q3 2022 OUTLOOK

JULY 2022

Banque Havilland, a well-established banking group offers services to both ***private*** *and* ***institutional*** *clients, who can benefit from the advantages of a robust banking platform located across seven financial centres. The bank was founded in 2009 in Luxembourg, where it has its head office, and today also has presences in Monaco, Liechtenstein, London, Dubai and Switzerland.*

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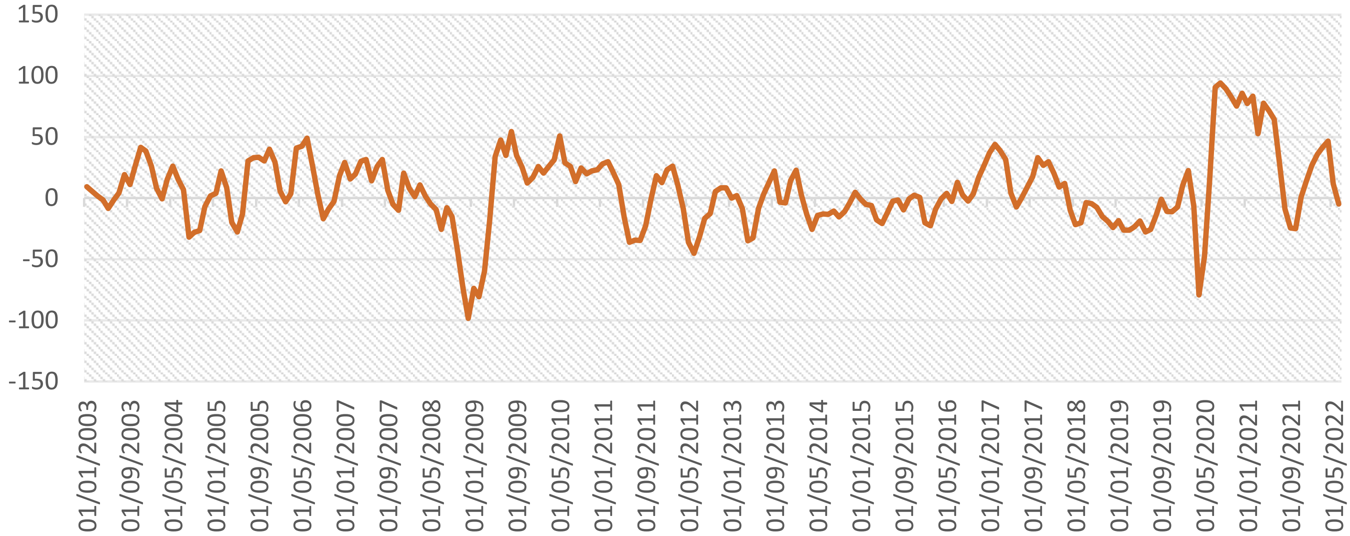
MARKET ENVIRONMENT

It is not controversial to state that market conditions are currently as challenging for investors as they have ever been. While many of us have experienced periods of slowing economic growth and equity bear markets (e.g. the great financial crisis of 2008), few of us have encountered falling markets, rampant inflation and monetary tightening all at the same time. Many assumptions and trends of the past few years have come to an abrupt halt in the face of higher prices, meaning investors are needing to readjust their outlooks and expectations accordingly. Inflation, dormant for so long, is at the centre of everything now it has been reawakened firstly by the ill-conceived switching on and off of the global economy in response to the outbreak of Covid, and then secondly turbocharged by the conflict between Russia and Ukraine. The foundations of this inflation were, of course, laid many years beforehand and the question of what the consequences would be after a decade and more of stimulus and artificially low interest rates appears to be being answered as CPI reading after CPI reading registers a 'higher than expected' number. The effect on investment portfolios of this has been profound, as the bond markets (namely Treasuries) have not provided the safe haven they have in previous equity market sell-offs. Indeed the relationship between high duration stocks (those with high future growth prospects and high valuations) and bonds has been very highly correlated this year, and with global investment grade bonds being down around 15% and most equity markets seeing double-digit losses as well, there has been nowhere to hide outside of commodities. We have long ben of the view that a central bank 'misstep' would be the most likely cause of a market rout, and it does indeed seem that all major banks are behind the curve when it comes to reeling-in inflation, that they universally insisted was 'transitory' until very recently.

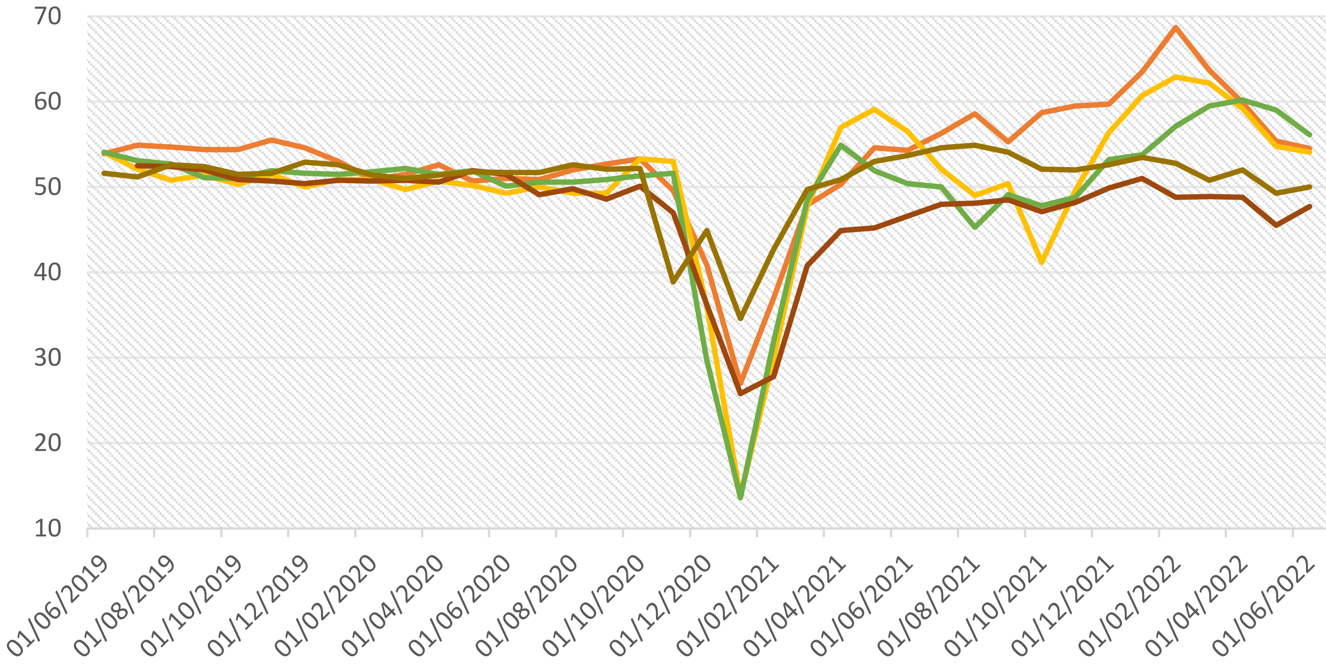
Citi surprise Index



The Citi Economic Surprise Indices measure data surprises relative to market expectations. A positive reading means that data releases have been stronger than expected and a negative reading means that data releases have been worse than expected.

Now they find themselves compelled to raising rates into a potential recessionary environment, thus exacerbating the economic situation. Inflation's resurgence during the past year has awakened fears that the global economy has returned to the 1970s – a period when growth stagnated and central banks lost control of price stability, but these fears are probably overdone because while today's inflation clearly isn't transitory there aren't many signs of it flowing through to wage demands (as it did in the '70's).

Composite PMI Readings



Economic optimism as seen here has peaked, but is still mostly in exapansion territory (above 50). Japan appears to be ticking upwards at last.

The employment statistics, therefore, will take on greater importance than ever as market participants look for signs that support or cast doubt on that thesis. We hope that supply bottlenecks caused by Covid start to unblock and the impact on commodity prices of Russia's invasion of Ukraine begins to fade, meaning price pressures will dissipate. There has been early evidence in some commodity markets of a cooling, not least copper that has retreated nearly 20% from earlier highs. Soft commodities and agriculturals have also started to retrace. Ironically a 'light' recession maybe healthy for the US economy in the longer term, as a drop in demand would naturally restrict inflation and save the Federal Reserve from being forced to hike rates further and stifling growth.

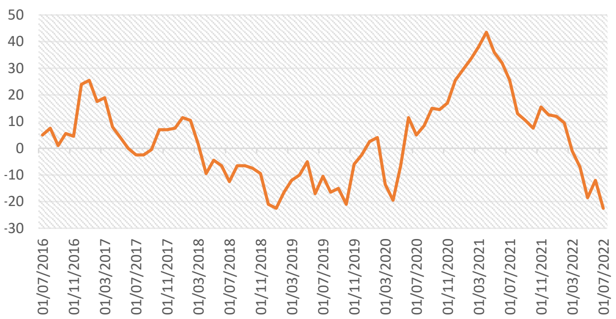
Baltic Dry Shipping Costs Index

The cost of shipping major raw materials by sea has fallen dramatically, this should alleviate some of the inflationary pressures.

> *“Many investors will not have experienced market conditions as treacherous as this in their lives, including most professional asset managers.”*

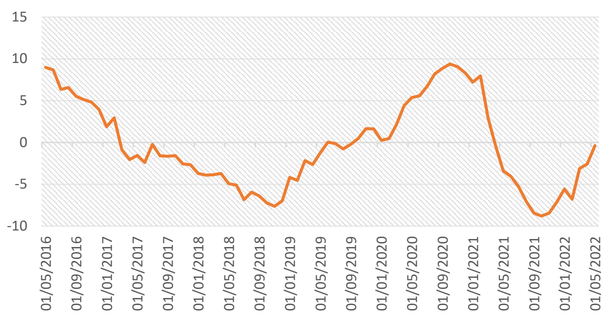
The next few CPI readings will ultimately determine the direction of all the major asset classes. Hopes are pinned on evidence showing that inflation is at least peaking, so that subsequently there is less pressure on central banks to tighten policy at a time when growth is slowing and talk of recession is rife. The point at which inflation levels plateau could mark the bottom for stocks, mark a line in the sand for bond yields and, importantly, see the US Dollar retrace. Many investors will not have experienced market conditions as treacherous as this in their lives, including most professional asset managers. With global equities down nearly 20% year to date and aggregated bonds down near 15%, there has been nowhere to generate positive returns outside of the commodity markets, and even those sold off heavily from their peak in early June. Duration assets continue to bear the brunt of the selling due to the diminishing value of future cash flows. Growth stocks, as epitomised by the US tech sector and small caps have been especially punished, while value companies have enjoyed relative success when compared, but many of which are still in the red for 2022. Whether a portfolio holds more of one than the other at this stage will depend on an investor’s view of the market from here, with duration assets showing signs of outperformance during bouts of optimism, before value takes back the mantle during selloffs. We believe that much of the medicine has been administered at this point, though continued volatility and perhaps a further leg down in equities can be expected before buyers return in a meaningful way. Earnings growth estimates are probably still too high and require further revisions, and equity valuations (while having retreated considerably) can further drop before they look attractive over the longer term. We suspect that most of the losses for both equities and bonds have already occurred, and there are reasons for optimism to suggest we are near the end of the bear market. We continue to believe that a “softish” landing for the economy is the most likely path forward, due to a strong consumer bolstered by accumulated savings and compensation gains.

US Investor Sentiment



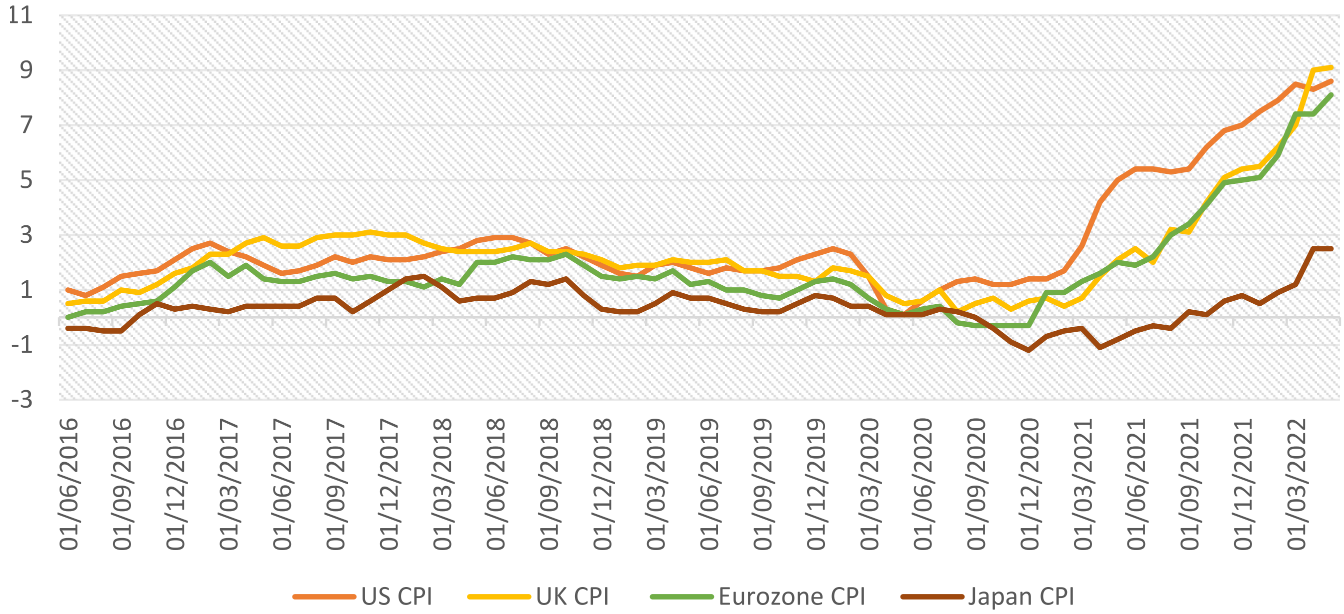
Investors are pessimistic at the moment, however, this could be seen as a contrarian buying signal.

China Credit Impulse Index



China’s credit impulse index (a measure of the credit cycle) has started to recover - a bullish sign for the economy.

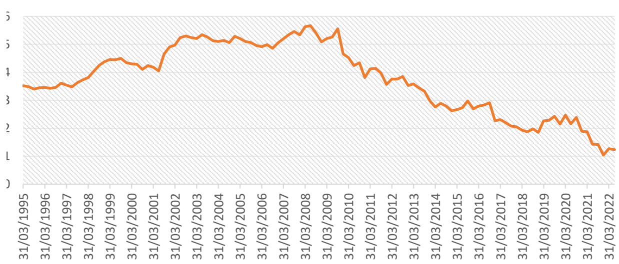
Inflation (year on year) %



Inflation has surged higher across developed markets. Until this shows signs of slowing down, economic and market conditions will remain challenging.

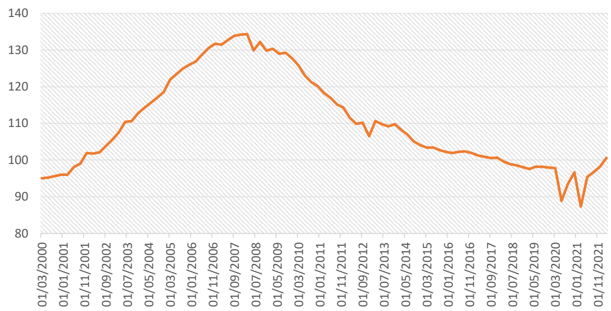
In the US and Europe, household finances remain pretty healthy as savings accrued during the pandemic years (the Covid 'piggy bank') have yet to be spent, while corporate balance sheets are also relatively strong – this should provide a buffer against higher prices, at least in the short term. Furthermore, growth in China finally appears to be ticking upwards as the country moves away from its questionable 'Zero Covid' policy and the latest credit stimulus starts to kick in, and likewise in Japan the economy is tentatively showing signs of life again. A resumption of trade and demand in the region should go some way to unlocking the supply-chain issues and shortages that are contributing to global inflation, and we should not forget that Chinese growth was a major driver of global growth since the turn of the century. It is also reasonable to expect that most of the negative sentiment and price action has already occurred. Nevertheless, we cannot be certain of the depth or length of a potential economic downturn, and history has shown that of the twelve times since the 1950's the Fed has proceeded with a major tightening cycle, nine have ended with a recession. Our strategy remains to hold higher levels of cash than normal, conscious of the fact that buying equities in the midst of a recession can be a very profitable exercise – especially in the early recovery stage – though as this is very hard to time in practice, staying largely invested at this point is crucial. Now is a time for battening down the hatches and weathering the storm, while remaining ready to take advantage of improving conditions in the next few months.

Net Debt/EBITDA - Global Equities



Corporate Balance sheets are pretty healthy with low debt, which is a cause for some optimism.

US Household Debt Ratio



Household finances (savings accrued during Covid) are relatively healthy at this point, meaning consumers have some initial buffer against higher prices.

EQUITIES

As we approach the third quarter of the year, most global stock indices are in the red due to the well-publicised fears of persistently high inflation, the subsequent monetary tightening response from the Central Banks and a deteriorating economic growth outlook. For equity investors the dominant feature of the market has been the unceremonious fall to grace of growth stocks that were already thriving in the low interest rate, pre-pandemic environment but then boomed in the stimulus-fuelled aftermath. In 2022, however, the table turned in favour of value stocks as the reality of hawkish central bank action ate into the appeal of expensively priced companies offering only high future cash flows. Many of the narratives and 's–tories' that were essentially all part of the same 'growth' movement have taken a severe knock this year, including social media platforms, cryptocurrencies, electric vehicles and ESG investing (most genuine ESG stocks are 'growth' in nature) – no doubt all will play their parts in the future but simply their pricing had simply become too far detached from their fundamental valuations.

While stock market analysis is part driven by models and maths, a catchy story is always required to substantially move market sentiment and investors can hugely profit from believing in it. So it proved with the multi-year outperformance of growth stocks (which are dominated by large US tech firms) that started with the acknowledgement of the potential of the tech sector being undervalued following the financial crisis of 2008, before morphing into a belief that successful long-term investing simply required finding companies with the best potential growth. Companies that did not fit this mould, (i.e. traditional consumer stocks, energy businesses, industrials etc) were left behind thus leading to an unnatural division of the market into growth and value stocks. Though the relative outperformance in 2022 has been marked, value investors have hardly enjoyed bumper returns with most 'value' baskets in negative territory albeit to a far lesser degree than their growth counterparts have.

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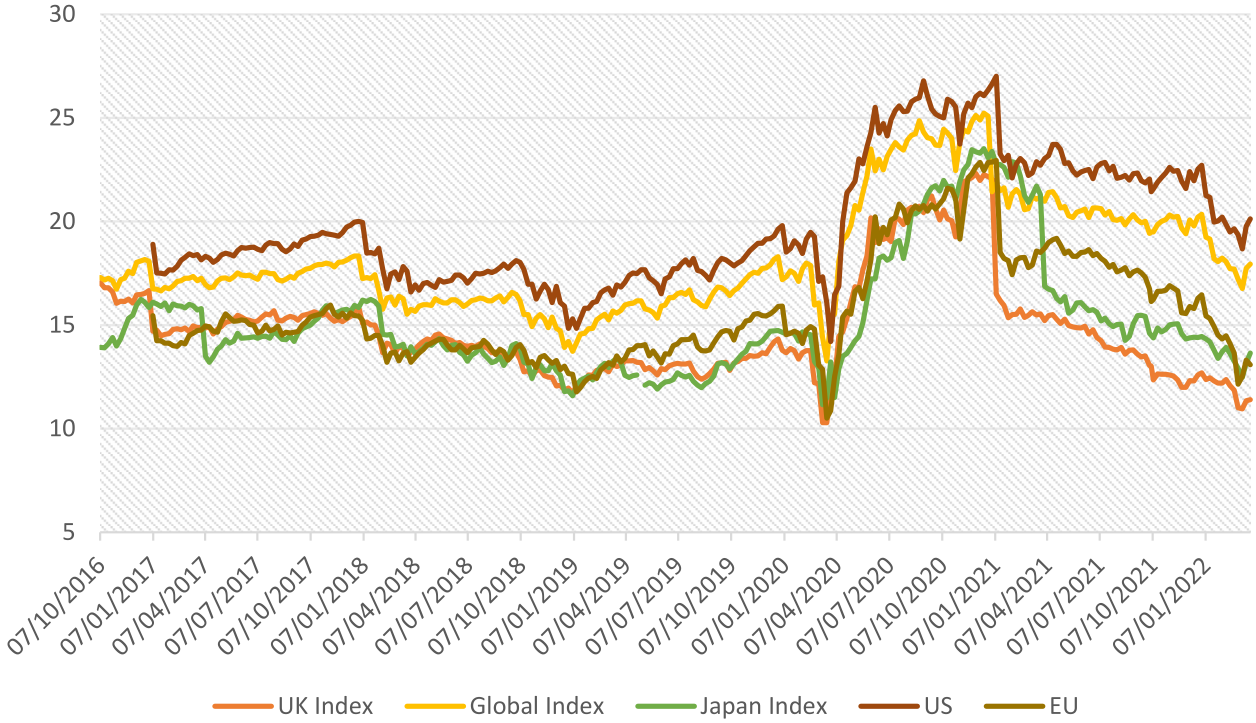
EQUITIES								**The US market is leading most global indices lower as the growth-led gains of the pandemic years unwind. Recession/policy fears are hurting sentiment, but much of pessimism is now priced in.**
US								Remains a very expensive market, supported by Federal Reserve liquidity and high investor participation. Growth stocks look set to be punished by higher rates.
UK								British stocks are at their cheapest versus global stocks for many years, and should benefit from the commodity/dividend bias.
Eurozone								Region is the most vulnerable to Russian exposure and energy restrictions, that may restrain growth. Selective opportunities, such as dividend stocks.
Switzerland								Quality, defensive nature of the market continues to see Swiss stocks in demand, though valuations rich now.
EM								We retain an allocation to emerging Asia for the long-term growth story, but other markets look less appealing. Sentiment has turned in China, with stimulus returning.
Japan								Attractive valuation for a developed market . Growth looks like re-emerging, currency has been a drag - all eyes on BOJ supressing yields.

We typically like to include a mixture of both so as not to be too exposed to either style and trust our security selection to outperform, but recognise that to achieve enhanced returns over the longer term; it is possible to tilt holdings to reflect our convictions and expected market conditions. Currently our view of the wider market in general is determining this: through this years' volatility it has been clear that where there have been short-term rallies, growth stocks have outperformed, but the longer downward trend has favoured value stocks. As such, until we believe the bottom of the current cycle has yet to be touched we will continue to focus on price and valuations, but when looking to increase risk assets in the future we will likely look to growth equities again. With the economic data across the world appearing to have peaked we suspect that value remains set to outperform in the medium term as economic growth declines. Indeed, this is starting to be reflected in companies' earnings: over the past month growth stocks estimates have noticeable slipped, while value stocks have actually seen improved estimates for the coming periods. Of course, a good number of these revisions are linked to the commodity sector, and as such, value stocks are not impervious from an economic slowdown. However, the prospect of substantially lower commodity prices from here currently seems fanciful as the war in Ukraine and the tight-oil supply are poised to keep prices elevated. Meanwhile, the tech sector is still valued above its' pre-pandemic level, and the latest CPI print in the US has once again forced the Federal Reserve to emphasize its mandate to curb inflation over the interests of equity investors – putting highly valued companies back in the firing line should equities remain under pressure. Value stocks that tend to offer more near-term cash flows and an already-diminished valuation, by contrast, should continue to outperform in the near term.Valuations in general have fallen some way from their highs, particularly for US stocks, but when seen in the context of the muddled fundamental outlook, it does not seem they have fallen quiet fair enough to yet be considered genuinely attractive. In particular, we feel that until earnings expectations retreat to more realistic levels there is scope for further imminent downside, especially for the growth/tech dominated US market. Having said this, US small caps now look oversold and are a contender in terms of an area to increase exposure to once we feel the time is right. We are also approaching European stocks with caution due to the likelihood of the ECB being further behind the Fed in terms of hiking rates, which suggests that they will have to play catch-up at some point, while the effects of the sanctions on Russia and higher energy costs will be more keenly felt in the Eurozone than elsewhere.

> *"While stock market analysis is part driven by models and maths, a catchy story is always required to substantially move market sentiment and investors can hugely profit from believing in it."*

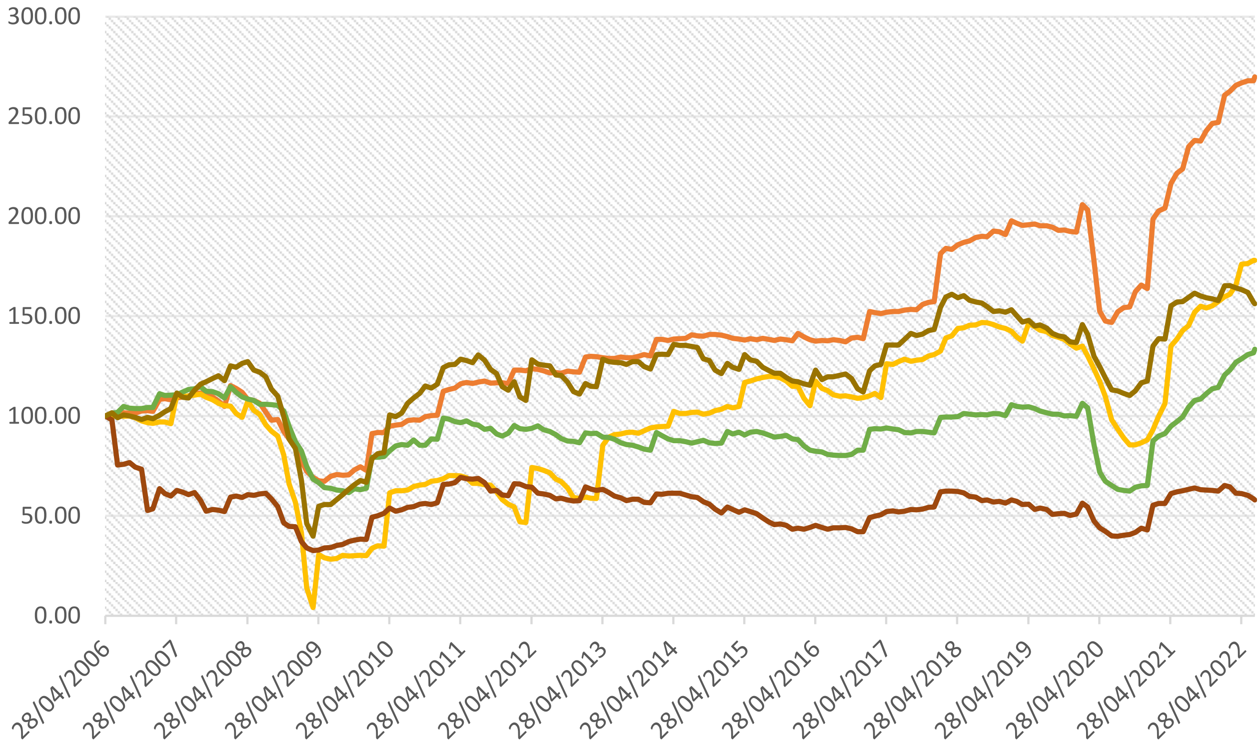
We continue to believe an allocation to Swiss stocks makes sense due to the solid defensive nature of the market, supported by a potentially stronger Franc now the SNB are raising rates, and the healthcare component of the Index is also attractive (with the sector looking a good bet in general). As mentioned earlier, Japan appears to be enjoying renewed economic momentum, while the Yen is extremely cheap, making its' stock market appealing to foreign investors – at the same time inflation remains remarkably low in the country and monetary stimulus is continuing at extraordinary levels. Likewise, in China, the closely watched credit impulse gauge is ticking up once more and equities are starting to follow, though perhaps a little more evidence that the draconian, economy-busting Covid lockdowns are truly a thing of the past before we commit more wholeheartedly to the market.

Equity valuations: 12M fwd P/E ratios



Valuations have retraced considerably, but probably need to drop further toward pre-pandemic levels before being genuinely attractive.

Earnings Expectations

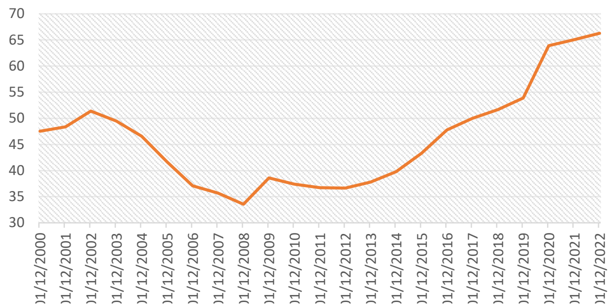


Earnings estimates (in the US especially) are too high and will probably be revised down before stocks find a bottom.

BONDS

The decline of the bond market in 2022 is essentially, what has caused traditional investors the biggest headache, with the capital preservation qualities of fixed income assets shot to pieces by the reality of that income being wiped out by inflation. Only the prospect of recession has been enough to curb yields in recent weeks, and whether market participants will long consider that a 3% yield on a Treasury is worthwhile with inflation approaching 10% remains to be seen. While investors are returning to bonds that offer some of the highest nominal yields in a decade, a radically different inflation environment means they face risks at every turn – be it a key economic data release or whenever a central bank official speaks. The new line in the sand for 10-year Treasuries looks to be 3.5%, now that 2%, 2.5% and 3% all failed to hold as inflation and the central bank's response drive yields higher. As stated throughout this Outlook, all hinges on inflation from here, but with CPI readings having consistently surpassed expectations for most of the past year, there is surely a real risk that 3.5% is soon breached in earnest and the next milestone set. Unfortunately for the wider asset class, the prospect of recession has seen the relative outperformance of the riskier parts of the market (high yield/emerging market debt) diminish; meaning even a strong diversification away from a traditional investment grade bond allocation has not wrought benefits. With the bond market essentially driven by inflation and Fed-hike expectations, we maintain our underweight outlook for the asset class. Even if the Fed does hike another 75 basis points in July (i.e. 200 basis points in three months and the biggest shift in history) this still only gets rats back to their 'neutral' rate of 2.5% - and chances are this will not be sufficient to halt inflation, with the dot-plot showing members expecting to take rates to between 3.5-4% in 2023. Historically 10 year Treasuries tend to peak around the time that Fed tightening does, and therefore this points to further distress for bonds until well into next year. While US Treasuries at least offer some yield (albeit negative in real terms), in Europe (despite the sell-off) yields are still very low and with the region faced with the challenges mentioned in the equity section above, together with a worsening inflation picture (Italy, Germany) it is hard to make a positive case for EU Sovereigns. With EURUSD hedging costs having spiked again this year, European investors are not even rewarded for the relative carry of buying USD bonds.

Emerging Markets Gross Debt/GDP %



Sovereign debt levels in developing markets is at record highs, hence we are cautious towards EM bonds as the cost of servicing this debt increases with higher rates.

We are not especially keen on corporate investment grade bonds either, as the prospect of monetary tightening (including less direct buying by central banks and governments) and the likelihood of cuts to earnings forecasts are not encouraging. There will be, of course, selective names that represent better value than others do, but generally, spreads have not widened so much as to be enticing at these levels given the fundamental backdrop. Given the amount of tightening priced in by the markets, particularly in the front end of the curve, and the high geopolitical and economic uncertainty, we think it will soon be time to move back towards neutrality on duration, as we will get to the point where rate hike expectations have been fully anticipated and flexibility and liquidity will be needed in order to be prepared for this. While we continue to attempt to diversify our fixed income bucket with highly selective US High Yield and Emerging Market debt, the time is not right to add further risk here while default rates remain eerily low in the former, and while a strong US Dollar and oil price cause volatility in the latter. Emerging market Sovereign debt defaults also tend to spike in the wake of a rate-rising cycle, and the debt to GDP ratio of many of these nations is moving away from comfort level. This leaves our only real conviction in securitised assets – one of very few fixed income areas to have held its value in the year to date and we remain of the view that fundamentals for European ABS markets are still strong with demand for new issuances outstripping supply at the moment, as carry is still relatively high and interest rate duration low.

2 Year Bond Yields

COUNTRY	MATURITY	YIELD + / -
SWITZERLAND	11/06/2024	-0.15
JAPAN	01/07/2024	-0.08
AUSTRIA	15/07/2024	0.39
FRANCE	25/02/2024	0.41
IRELAND	18/03/2024	0.46
GERMANY	14/06/2024	0.48
NETHERLANDS	15/07/2024	0.54
FINLAND	15/09/2024	0.56
BELGIUM	22/10/2024	0.57
PORTUGAL	15/02/2024	0.71
SPAIN	31/05/2024	0.74
DENMARK	15/11/2024	0.81

COUNTRY	MATURITY	YIELD + / -
ITALY	30/01/2024	1.02
ISRAEL	30/11/2023	1.68
SWEDEN	13/11/2023	1.39
GREECE	02/04/2024	1.46
BRITAIN	22/04/2024	1.77
HONG KONG	23/05/2024	2.26
AUSTRALIA	21/04/2024	2.46
NORWAY	14/03/2024	2.47
SINGAPORE	01/09/2024	2.55
UNITED STATES	30/06/2024	3.00
CANADA	01/05/2024	3.14

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FIXED INCOME				**High inflation has rendered most bonds' income profile negligible. We think yields have further to go before the asset class becomes genuinely interesting again.**
Sovereign Bonds				Sovereigns offer short-term safe harbour in time of market stress, but yields are being punished by inflation. US 10yr at 3.5% is next key level.
Corporate I.Grade Bonds				Buyers may soon come back with 4% yields for corporates on offer, but the real return profile remains poor. Inflation needs to subside.
High Yield Bonds				Yield pick-up is still relatively attractive, but low historically. Default risks are a concern, but low nevertheless.
E.M. Bonds				Local currency appreciation in an economic recovery, together with meaningful yield pickup make certain EM bonds relatively attractive. Short duration.

CURRENCIES AND COMMODITIES

The strength of the US Dollar persists as a powerful theme this year, with the clear daylight between the Fed's actions (and rhetoric) to date and the other major central banks' hesitance to tighten being the main driver of the greenback. Falling markets and general volatility with the geopolitical backdrop of the Ukraine/Russia war have also seen the reserve status of the Dollar push its value higher due to the safe-haven appeal, as nervous investors seek liquidity above all else. A strangely hesitant ECB contrasts with a more aggressive Fed, worries about natural gas supply disruption and economic recession are deepening, and scepticism on the ECB's pre-announced anti-fragmentation program is growing. The more hawkish shift in communications from Christine Lagarde ("inflation pressures are broadening and intensifying") gave the Euro a short-lived reprieve from the recent 20-year lows, before FX markets concluded a 25 basis point hike was not sufficient to prevent the ECB from falling further behind the curve in comparison with the Fed. The single currency now risks falling to parity with the Dollar before any recovery is apparent. The Japanese yen, so long a safe-have currency itself, has seen its value depreciate by nearly 15% this year as the Bank of Japan has appeared willing to accept this as a cost of artificially suppressing its sovereign bonds via yield curve control (0.25% cap on the 10 year). It Is not clear quite how much currency weakness the BOJ will tolerate, but with global inflation yet to show itself in Japan there is less pressure to tighten policy than elsewhere. With some major foreign market participants revealing they are placing heavy bets against Japanese bonds, it is likely the BOJ will need to shift their cap a little that could see a reprieve for the currency, but for now the policy divergence versus other central banks remains notable.

US Dollar - against a basket of other currences

The Dollar has been in a strong bull market for two years. A softening is required for the global economy to prosper.

The Swiss National Bank surprised markets in June with its first hike in years, as it was forced to confront inflation, and indicated more may be necessary; so all else being equal we expect the Franc to outperform the other European currencies and maintain its reputation as a steady shelter for investors with the central bank well-known for not wanting CHF to strengthen too much (due to the country's exporting prowess). While the Bank of England sits somewhere in between the Fed and the ECB in terms of its tightening agenda, Sterling is currently highly correlated with the Euro and the pair are being buffeted about simultaneously by the Dollar. Ultimately, the FX market in the medium term will be directed by the path of inflation in both the US and other major currency nations, and the accompanying monetary responses of the corresponding central banks and whether growth or recession transpires in these economies, therefore a wider sense of inflation peaking and economic growth returning on a global basis will almost certainly see the dollar start to weaken from its elevated position. A ceasefire between Ukraine and Russia could be a fillip for global financial markets and currencies generally, but unfortunately, with Moscow insisting on complete surrender and a large majority of the Ukrainian population strongly supporting continued military resistance, no end to the war is in sight. Since our last outlook commodities have taken a breather, largely because of the fears that a coming recession will see a reduction in demand and while we do not foresee a rapid rebound to previous highs, there are structural reasons for believing the outlook continues to be fairly positive for 2022's best performing asset class. There is a natural demand destruction that takes place as prices get too high, as end consumers readjust, but there are offsetting factors, in particular for energy stocks such as the Chinese economic growth and the current surge in air travel following the reopening of the economy. The removal of around two million barrels of Russian crude a day from the oil market is not easily replaced, a point not missed by OPEC+ who have been reluctant to increase production despite the pleas of Western leaders, while US and European producers having been encouraged to reduce production/investment in fossil fuels in recent years are not able to quickly raise output either. Opec believes that oil and gas demand will rise steadily to around 106 million barrels a day in 2030, before starting to decline in 2035. This partly reflects the fact that demand for electricity is growing faster than renewable capacity can keep up. According to the International Energy Agency, global electricity needs rose 5% last year, with fossil fuels generating 45% of the extra demand. New renewables capacity is expected to cover only about half the extra demand this year. The transition to renewables will lean heavily on fossil fuels in the interim, and while we can expect the usual oil surplus/shortage cycle to continue, this should create enough demand to offset an economic downturn keeping Crude above $100 in the medium term. Our view that Oil will remain elevated and the significance of this with respect to inflation suggests that even after CPI's peak, they will not return to settle at levels seen prior to this year. Sticking with the subject of green energies, the sizeable pullback in the copper price surely presents a buying opportunity due to the reliance of clean energy technologies, for example, electric vehicles require four times more copper than a traditional combustion engine. After a thoroughly disappointing year in 2021 when negative real rates were peaking, 2022 has been yet another false dawn for precious metals that have not gained in value as one might hope in a period of geopolitical risk and market volatility. Gold has performed relatively well as a store of wealth, however, certainly more so than the fixed income market and in fact for EUR and GBP investors an unhedged holding in the yellow metal will have been a positive holding. In our view, the main attraction of precious metals is their uncorrelated relationship with other financial assets, and this investment case remains intact in our view.

Commodity Index

Commodities have been the only asset class to perform positively this year - it remains a good inflation hedge.

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Citywire 2019: 'Top 30 Influential Fund Selectors'

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