BANQUE HAVILLAND

Q4 2022 OUTLOOK

OCTOBER 2022

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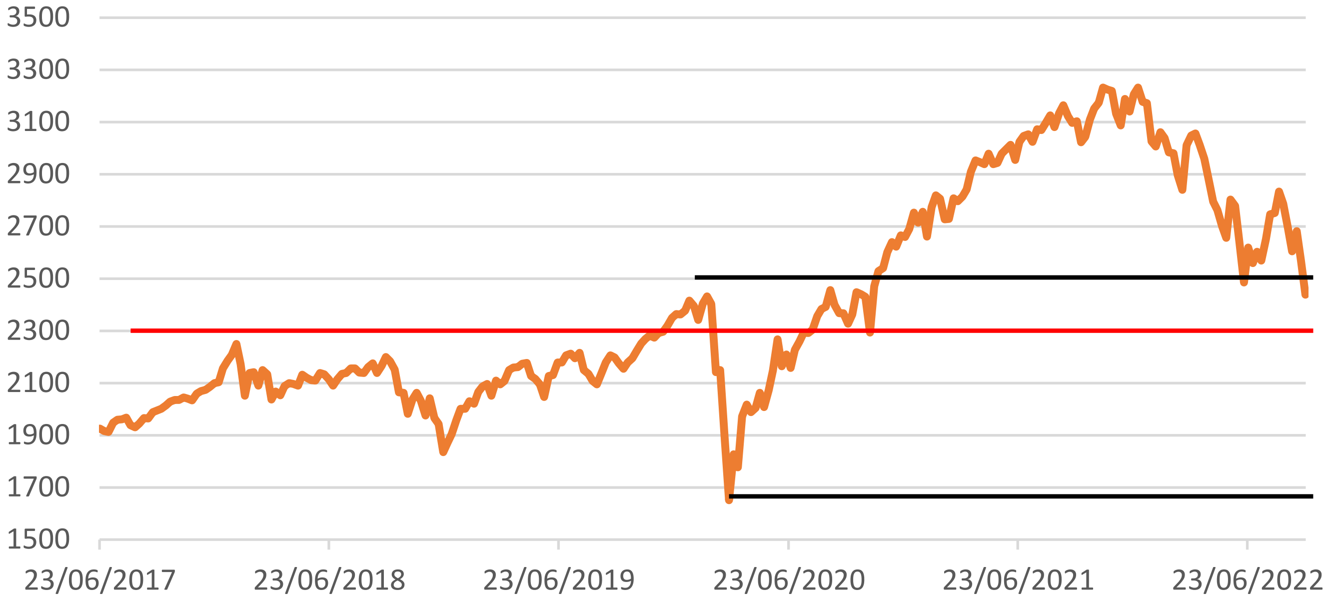
MARKET ENVIRONMENT

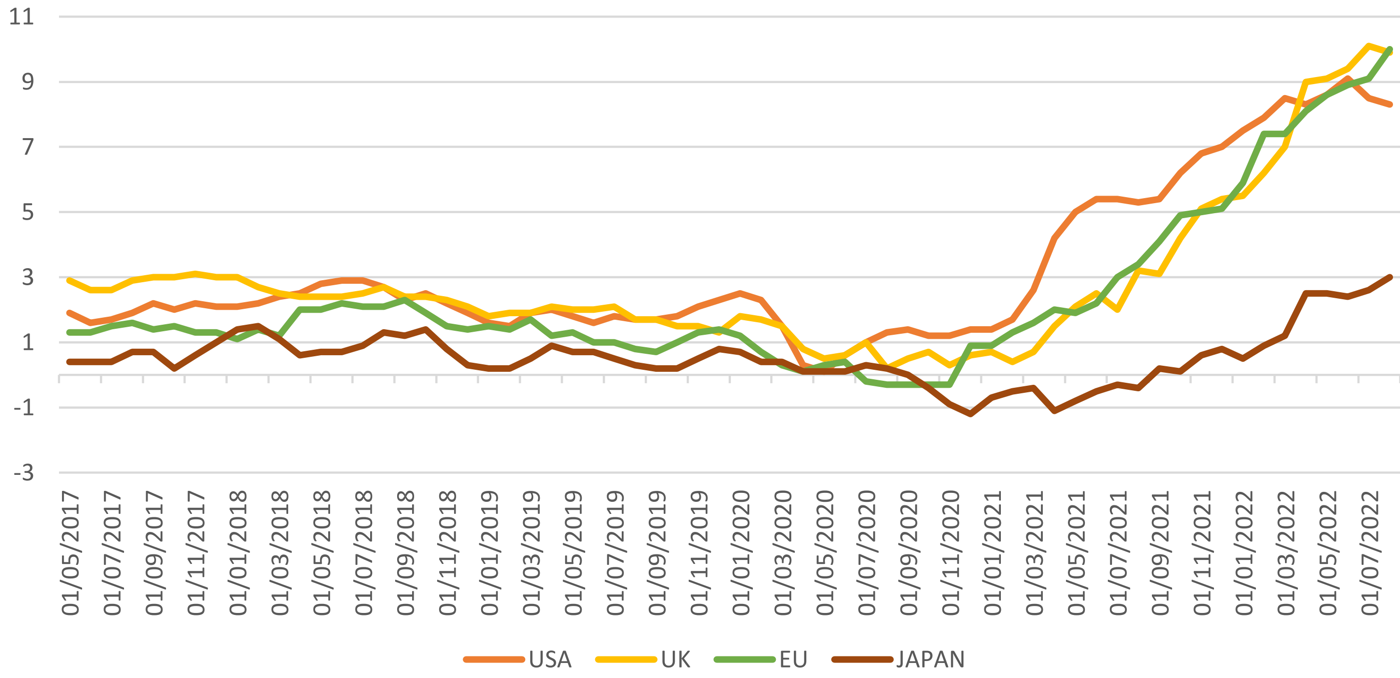
This year has proven to be the most difficult in a generation for investors, with both major asset classes (bonds and stocks) looking at 20% declines to date, meaning a split portfolio of any ratio is also looking at 20% loss as the diversification benefits of a traditionally managed allocation has not offered any protection. Furthermore, with a couple of exceptions, there has been little variation amongst sub-asset classes for investors to exploit or outperform benchmarks or peers. For example in the equity markets the US, European and Chinese indices are all down around 20%, while in fixed income the Investment Grade Global Index is down around the same while High Yield bonds have done slightly better at about -18%, and Emerging market debt worse still at – 23%. Commodities, led by energy prices have been the only bright spot and have therefore fulfilled their role as an inflation-busting asset class, but precious metals (though down less than equities and bonds) have not been the safe haven we would have liked to see. With respect to currencies the US dollar “smile theory” proved once again reliable, with the greenback outperforming all other major pairs and providing some shelter for some investors. The reasons for this market behaviour is, of course, no mystery as central banks have begun raising rates in earnest to combat post-pandemic inflation, and while there have certainly been rate-hiking episodes in the past, never have they had to be lifted from such a sustained low base as currently. For the past decade or so, in the wake of the financial crisis the US base rate has been less than 1% with much of that time being at 0.25% - compare this to the previous major hiking cycle in 2004 when rates were lifted from 1% to 5% when the preceding decade had seen an average base rate of over 4%.

Global Equities



Equities are in a bear market, nearing a 30% fall from their peak. We think a good buying opportunity will be when they hit pre-pandemic levels, as indicated by the red resistance line.

Inflation (year on year) %

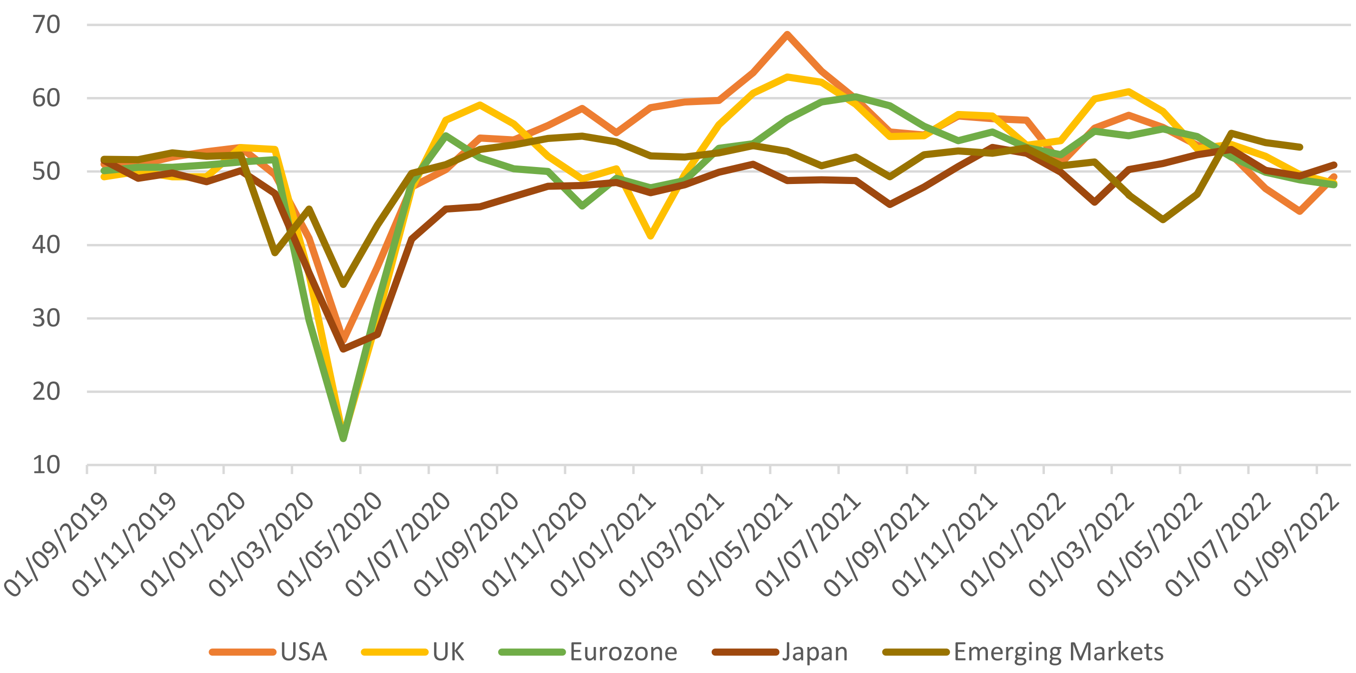


Inflation is high - has it peaked though?

Quite clearly then, a major factor in the current bear market is the financial world facing up to the reckoning following an extended period of artificially suppressed monetary and fiscal policy, which is finally expressing itself in the form of markedly higher inflation. The Russian invasion of Eastern Ukraine, and the energy supply shock it caused proved to be the primary catalyst for the sustained sell-off and higher inflation we have experienced this year, but we would argue that most developments in the landscape of financial markets should be seen through the prism of a tightening monetary backdrop, and while the US Federal Reserve leads the charge in this respect a stronger US Dollar will continue to dominate sentiment. With potentially the majority of the market retracement behind us (average bear equity market tend to bottom at around -30%), we find ourselves looking to the future and towards the end of the current cycle in order to be well positioned for the recovery stage that surely will come once rates have peaked.

As ever, we find ourselves attempting to discern the difference between short-term markets movements and long-term fundamental drivers of markets and as such are avoiding being tempted into ‘buying the dips’ which has not been a good strategy in 2022. It was no surprise that July and August saw an oversold bounce that retraced a portion of the years’ decline, but since then most markets have subsequently dropped lower than June’s level and the danger is now that a further, deeper low is on the cards amidst worsening fundamentally-driven sentiment. Indeed, our technical analysis suggests that major equity indices will likely look to touch levels seen 2020 pre-pandemic levels before investors can really start to think about deploying more capital into risk assets. On the positive side, this does not look too far away and as such we encourage holding higher cash levels than usual in anticipation of a decent buying opportunity.

Composite PMI Readings

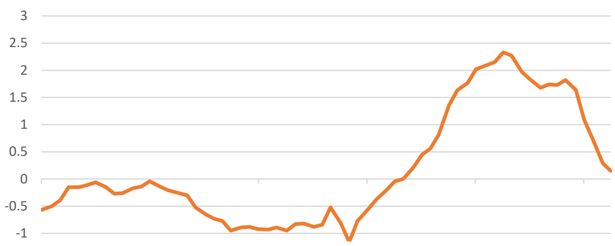


Corporate confidence has been trending downwards since mid-2021, and is generally hovering around the 50 mark, below which indicates economic contraction.

For clues on when this opportunity may arise, we of course need to see signs of inflation starting to roll over as this is what the Fed and other central banks are preoccupied with, while being cautious that any such signs are not false dawns as they proved to be in the late summer of 2021 or in the spring of 2022 when inflation surged following weaker CPI prints. Encouragingly, there are indeed signs that higher prices are at least starting to peak – especially in the US, where the last two CPI readings have been lower, and the so-called "base effect" of commodities should also provide some support. Much of this can be put down to weaker energy prices, however, and the turn in core goods and services prices has yet to obviously peak. Although globally, the trend appears to be turning downwards, in Europe it is not due to the exposure of the European economy to higher gas prices, and there will be undoubtedly be a lag in European growth versus the US until energy prices settle, with the weak euro complicating further the situation on the import side. In terms of the global supply disruption, pressures appear to be easing here too: bottlenecks are easing, supply constraints are improving rapidly and global freight costs have fallen dramatically – if not quite to pre-pandemic levels. Commodities, at index level have also fallen approximately 15% from their June peak. Naturally, there will be a lag before these factors wash through into the global economy and it notable that the labour markets both sides of the Atlantic remain tight, so we expect to see inflation readings to remain elevated in the next few months, but it is clear that there is good reason to believe we have seen peak inflation. Furthermore, looking at the forward-looking breakeven rates, the market is implying that inflation is already set to come down on a 2, 5 and 10-year basis.

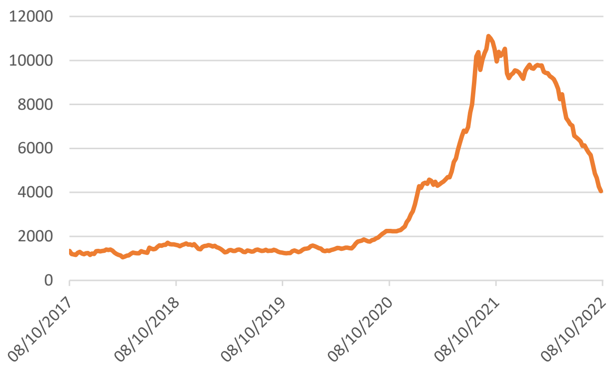
Recessions around the world are looking increasingly imminent, however, and the one thing that could truly derail expectations of peaking inflation would be if central banks get cold feet when faced with deteriorating data and stop hiking prior to the inflation fire having been fully extinguished. Though the Fed has been hiking aggressively from a low base, we should consider that global monetary policy remains historically loose – and while this may lead to a short-term bout of risk asset outperformance (led by duration assets), even more rate rises would then be needed down the line.

Global Supply Chain Pressure



Global supply chain pressure has fallen from its 2021 peak, this should eventually feed through to ease inflation.

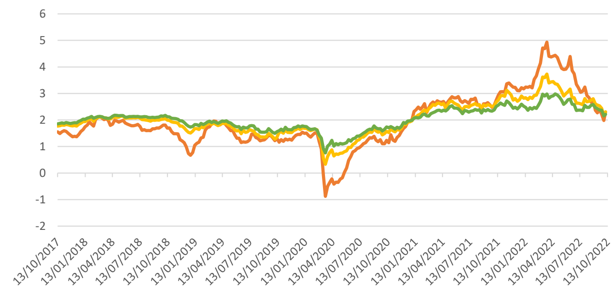
Global Ocean Freight



Shipping costs have fallen back a long way since their 2021 peak, which will help bring down inflation.

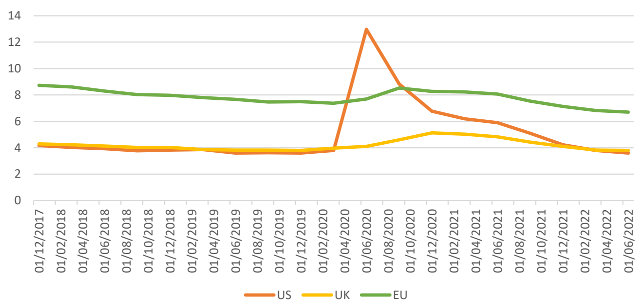
We hope that central banks stick to their word in properly controlling inflation, even if this means potentially overshooting, so markets can at least identify a clear bottom, from where fundamentally sound companies with realistic growth profile can flourish, rather than another unsustainable bubble characterised by excessive multiple expansion and high leverage. Nevertheless, we do not expect rates to rise too much due to the large debt burdens both at government levels and in certain consumer areas e.g. mortgages, so if rates do peak around midway through next year as expected then we can expect a looser monetary environment in the second half of next year and more conducive environment for financial markets. As equities are forward looking we expect to see buying opportunities emerge some time before then.

US Breakevens - Implied Inflation



US Breakevens, as calculated by by subtracting real yields of the inflation-linked maturity curve from the yield of the comparable Treasury maturity, point to inflation having already peaked.

Unemployment rate

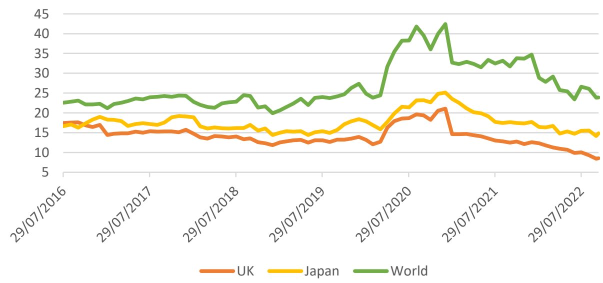


The jobs markets remain tight, and while this remains so, central banks will maintain their inclination to tighten policy.

EQUITIES

As above, our cautious view leads to us to remain underweight equities for the time being while we wait for a clearer opportunity to add to risk as the inflation/rates narrative progresses, but nevertheless it is important to stay invested in general while paying close attention to the sub-asset allocation styles and regions. There continues to be scope for further downside risk for stocks, given that valuations could yet further re-rate and earnings expectations that quite possibly have still not fully factored in the ongoing central bank tightening and increased recession risk. From a macro perspective, the Purchasing Managers' Index (PMI) remains the best way to forecast corporate profit trends and, unfortunately, PMIs continue to decline with S&P profits likely to follow and turn negative over the next six months.

Valuations - P/E ratios



In terms of 12 month forward price/earnings ratios, the UK and Japanese markets are cheap compared with the rest of the world.

Ironically, higher prices for goods and services are the very reason that earnings have held up to date, helping cushion margins and profits as companies pushed price to offset cost pressures. Specifically, we expect 'high-duration' stocks and those with high earnings multiples to continue to de-rate and bear the brunt of stock market volatility as their earnings-per-share are more prone to downgrades. Stocks continue to react aggressively to earnings misses or lowered guidance, indicating that the market is struggling to discount an appropriate level of future profits. Likewise companies with high amounts of balance-sheet debt will be vulnerable to re-financing costs which the markets will not look favourably upon, so in general this leads us to favour high quality companies at reasonable valuations with strong balance sheets with a defensive slant. However, we are cognizant that this environment will not be perpetual and that the time to position portfolios for the next leg of the cycle will soon be upon us. It's important to remember that the market is a forward-looking discounting mechanism and will make its bottom before earnings and the economy trough.

In terms of regional allocation, while the US economy does not look especially hot, it seems to us to be more appealing than Europe with the Fed being further along its tightening schedule than the ECB and without the energy shortage problem due to it's own hefty sufficiency, and US stocks have historically been more robust in recessions than others – and we think a valuation-conscious approach will outperform in the near term. The growth area of the market, personified by the tech segment continues to re-rate, but we have noticed that US small caps seem to have turned a corner and have decoupled somewhat from the general direction of the wider market. Small caps stand to do well in a recovery situation, so we are looking to build our exposure here. In Europe, the cyclicality of the market suggests a global downturn is negative for earnings in the region, with the impact of higher prices yet to truly impact corporate profits via a consumer spending slowdown. UK stocks are astonishingly cheap. They trade at almost half the peak blended forward PE ratio reached before the Brexit referendum and these are earnings-based valuations so with respect to the political noise the pessimism should be largely baked in already. With the pound at near all-time lows, the market looks very appealing to non GBP investors and furthermore UK companies have just been told a planned corporation tax hike will be reversed.

Once the hysteria over the much-maligned 'mini-budget' has died down, the market should start to appreciate that the landscape is much more business-friendly than before. Alongside the UK, Japan is our other conviction country as it continues to open up following the Covid pandemic, and pent-up demand among both consumers and businesses should underpin a growth rebound, while set against an ongoing backdrop of fiscal expansion and monetary easing. Japan, according to the IMF, is one of the few developed nations to see positive growth in 2023, and like the UK market has a currency that could well recover nicely, benefiting foreign investors. In particular, a more domestic-focussed approach to Japanese companies should shield against a wider global economic slowdown. With respect to emerging markets geopolitical risks and uncertainty remain elevated, leading us to keep a cautious stance short term, however, we note that many emerging nations have long been raising rates so are ahead of the curve in terms of quelling inflation, and are trading on attractive valuations. It is no coincidence that two of these markets, Brazil and the UAE are both energy exporters. India has also been a remarkable case, with its structural growth holding up and the equity market barely in a drawdown for the year. We are more cautious on China than in previous Outlooks due to the sporadic lockdown policies that curtail consumer spending and economic activity in general, while there is an obvious property bubble that casts a shadow over the wider markets. Policy remains accommodative though and the long-term growth story is still valid though perhaps not to the extent it was on a risk/reward basis.

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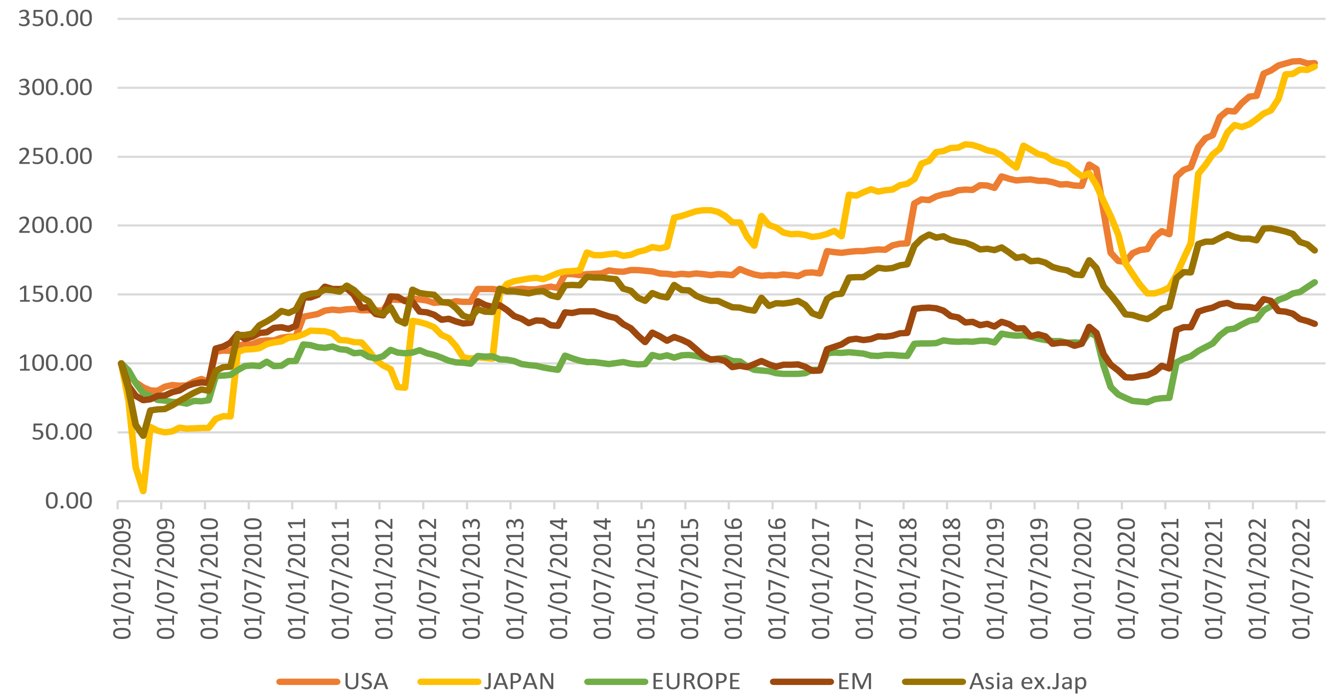
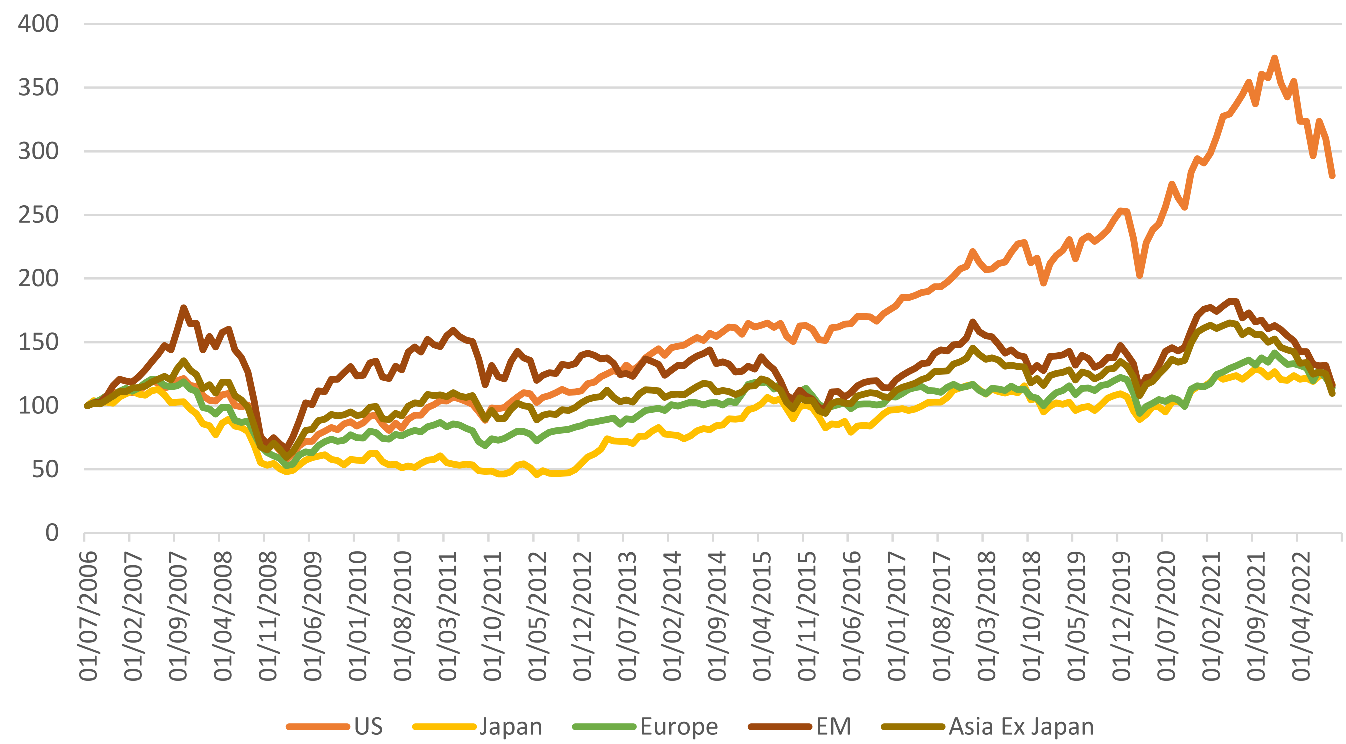
EQUITIES								**The bear market has resumed without an obvious catalyst for a recovery. A defensive stance is sensible with a focus on quality and valuation.**
US								Equities are being directed by rate expectations at the moment, and while the US economy looks better placed than elsewhere, its' growth bias makes it vulnerable
UK								British stocks are at their cheapest versus global stocks for many years, having recently sold off heavily. GBP assets cheap.
Eurozone								Region is the most vulnerable to Russian exposure and energy restrictions, which earnings estimates are yet to reflect.
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. USD strength is a headwind.
Japan								Attractive valuation for a developed market . Growth looks like re-emerging, currency has been a drag - all eyes on BOJ supressing yields

Earnings Estimates - Regional Indices



Analyst's expectations for earnings estimates are still trending up for developed markets...

Total Earnings - Regional Indices

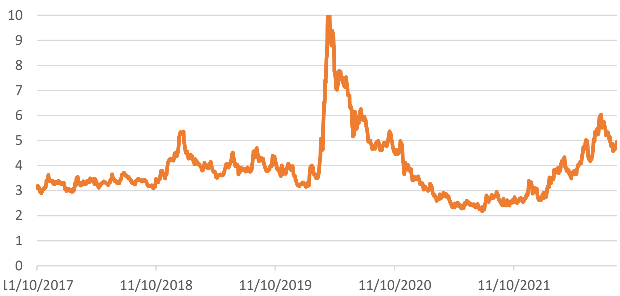


...but actual reported earnings are clearly in reversal, this could be the precursor to another leg down for equity markets.

FIXED INCOME

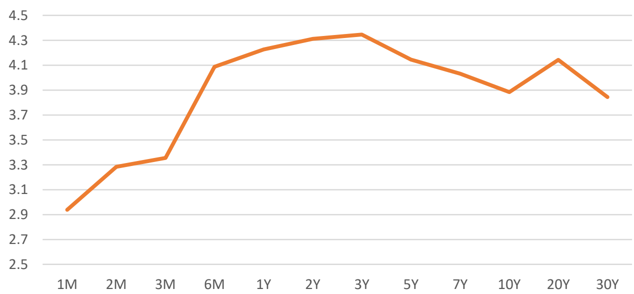
The bond market overall remains a riskier asset class than historically, though admittedly with yields having risen substantially in recent weeks fixed income does look more attractive than it has done for the past couple of years or so. With benchmark yields now at around 4%, returns from holding bonds will at least be expected to deliver more in line with long-term averages, and as we know yields are seemingly capable of touching zero or even below zero, there is scope for capital gains in the event of weaker than expected growth and lower inflation. This may hold true for the medium to longer term, but for now we are still early in the monetary tightening journey while inflation remains elevated and this backdrop is simply not favourable for assets with fixed income streams. Based on current market expectations we are still 100-125bps away from this. Meanwhile, the Bank of England and the European Central Bank still have 375bps and 225bps of tightening to do, respectively, over the next year (based on the difference between the current rate and the one-year forward). Like equities we anticipate over the cyclical horizon to have good opportunities to add risk to portfolios in both duration and spread positioning though these opportunities are likely to be greater in time, so we continue to err on the side of caution, waiting for further stabilisation. The risks appear skewed to the downside, and much is dependent on unpredictable inflation readings in the near term. Likewise in our duration stance we continue to be slightly defensive, maintaining a neutral/underweight positioning given the near-term inflation risks, and quite frankly there are now more appealing returns on offer in low-interest-rate risk fixed income assets that negate the need to look at duration. If we were forced to choose between sovereign debt markets then we would choose US Treasuries over European Govies, with Treasuries as cheap as they have been for a decade, and with the Fed being further progressed down the hiking cycle than the ECB and inflation more likely having peaked in the US than in the Eurozone. The European Central Bank is behind the curve compared to the Fed and its capacity to curb inflation is constrained by the ongoing energy supply crisis, and with both regions facing recession to some degree. Either way, buying such bonds in either market for a foreign investor makes little sense: for EUR or GBP investors buying USD debt with the Dollar at a stretched valuation is risky, while the negative yield differential between the comparative maturities will not make sense for USD investors.

US High Yield Spreads - 10 yr maturities



High Yield bonds have re-rated to approximately 6% premium over Treasuries - historically this is an attractive level to buy.

US Treasury Actives Yield Curve



The 2yr, 3y and 5yr Treasury yields remain higher than the 10 and 30yrs - i.e. the curve is inverted, which is often seen as a sign of coming recession.

Another reason for caution with respect to fixed income is the prospect of the Bank of Japan at some point loosening its yield curve control mechanism, whereby the central bank buys Japanese Government bonds to ensure the value (yield) of it's sovereign debt remains constant. While inflation in Japan is low compared to the rest of the world, it is well past the BOJ's target of 2% with interest rates still negative in the country – any move to 'normalize' policy by raising rates or to cease buying its own bonds could have a profound effect. The shock of higher yields would be felt in many other regions, where Japanese investors hold large amounts of overseas government bonds – in particular France and Australia, where they own 19% and 12% respectively. We think there is an outside chance of this happening as the Japanese administration is cautious by nature and breakout inflation just does not seem likely – but it is a theme worth paying close attention to. We don't yet feel that Corporate Bonds are yet attractive enough in terms of yield to allocate to rather than Sovereign bonds, in short they are not fully pricing-in the unfavourable backdrop as much as they should be relative to Sovereign bonds. While the overall yield of this market segment has indeed moved to more eye-catching levels, the spread (i.e. the difference between the yield of the corporate bond over the corresponding government bond) has not actually widened especially far yet, so until these move back in line with more historical norms we would prefer sovereign debt. High Yield bonds look more attractive to us on a relative basis as the spreads have meaningfully widened this year to around 6% over Sovereigns meaning many bonds in this space are yielding over 10%. The need to be highly selective in this space is always important and with rates on the up, this is even more pronounced as defaults will surely increase in the lower-quality end of the market – nevertheless we favour many opportunities in the BB credit space, where a focus on quality should offer a good return.

2 Year Bond Yields

COUNTRY	MATURITY	YIELD + / -
MEXICO	27/04/2025	4.50
UNITED STATES	30/09/2024	4.31
NEW ZEALAND	15/04/2025	4.19
BRITAIN	22/04/2024	4.11
SOUTH KOREA	10/09/2024	4.11
CANADA	01/08/2024	4.05
BRAZIL	15/04/2024	3.87
AUSTRALIA	21/11/2024	3.26
ITALY	15/08/2024	3.05

COUNTRY	MATURITY	YIELD + / -
GREECE	02/04/2024	2.56
SWEDEN	12/05/2025	2.40
SPAIN	31/05/2024	2.11
CHINA	25/06/2024	2.01
PORTUGAL	15/02/2024	1.93
FRANCE	25/02/2024	1.76
GERMANY	13/09/2024	1.75
NETHERLANDS	15/07/2024	1.72
SWITZERLAND	11/06/2024	0.54
JAPAN	01/10/2024	-0.07

Asset/Mortgage backed bonds also are an important part of our allocation and have performed relatively well in a year that has seen double-digit losses for most part of the fixed income market. The global property market is starting to feel the strain as mortgage costs rise with higher rates, as shown by US housing lead indicators while inflation will clearly squeeze the consumer but so far, these headwinds have not translated into a meaningful impact of European ABS performance. From a valuation perspective, the case for European ABS is also still decent and has increasingly become more so due to an increase in relative value versus corporate credit: high carry coupled with low interest rate duration.

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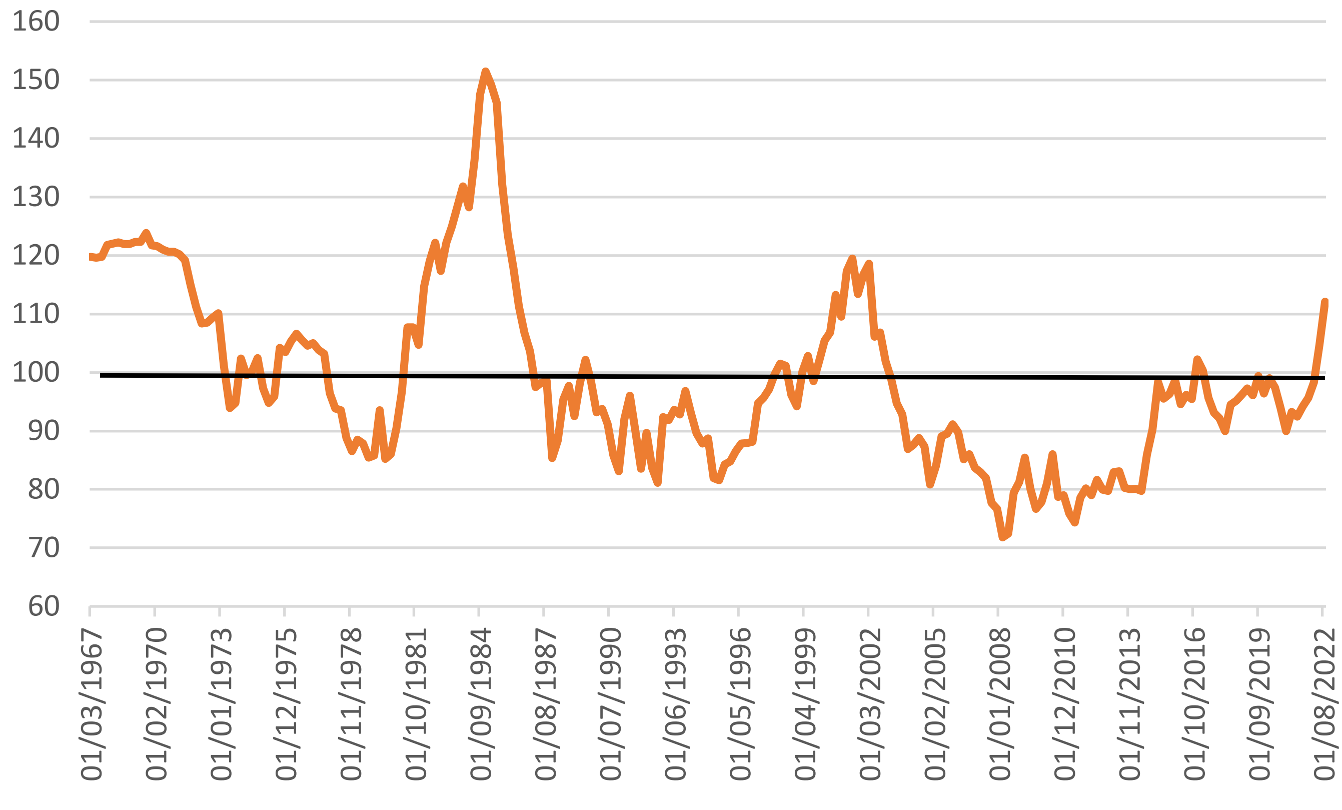
FIXED INCOME								**High inflation has rendered most bonds' income profile negligible. We think yields have further to go before the asset class becomes genuinely interesting again.**
Sovereign Bonds								Sovereigns offer short-term safe harbour in time of market stress, but yields are being punished by inflation.
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								Rallied with risk assets in July. Defaults remain low, but a selective approach needed. Duration is looking more appealing now.
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

One of the few ways a non-USD investor could have outperformed this year would have been to hold Dollar denominated assets, as the world's reserve currency has crushed all before it. With the Federal Reserve base rate at 3.25% and the Fed apparently more willing to make larger hikes, other central banks have been left trailing in its wake and their currencies have thus sold off relative to USD – that the other majors have seen small moves relative to each other tells the story of Dollar dominance. Then with the global economy sliding towards recession there is further demand for the safe haven and liquidity that the Dollar offers. In line with our views inflation has a few months more to go before peaking along with the accompanying rate hikes, it is difficult to see anything other than continued greenback strength over the same period, with the Dollar index likely to reach 120 before meeting real resistance. For portfolios this means holding more USD exposure than usual, and for USD portfolio only a minimum in foreign currencies. The time for reversing this view will probably run simultaneously to when investors should look to increase risk in general, and it would be prudent to start the transition to greater home currency weighting within portfolios soon. Several countries, either directly or indirectly (via the bond market) have taken moves to support their currency already, including the Banks of England and Japan, so it is probable we will see the peak in Dollar strength next year.

Dollar Index - 50 years

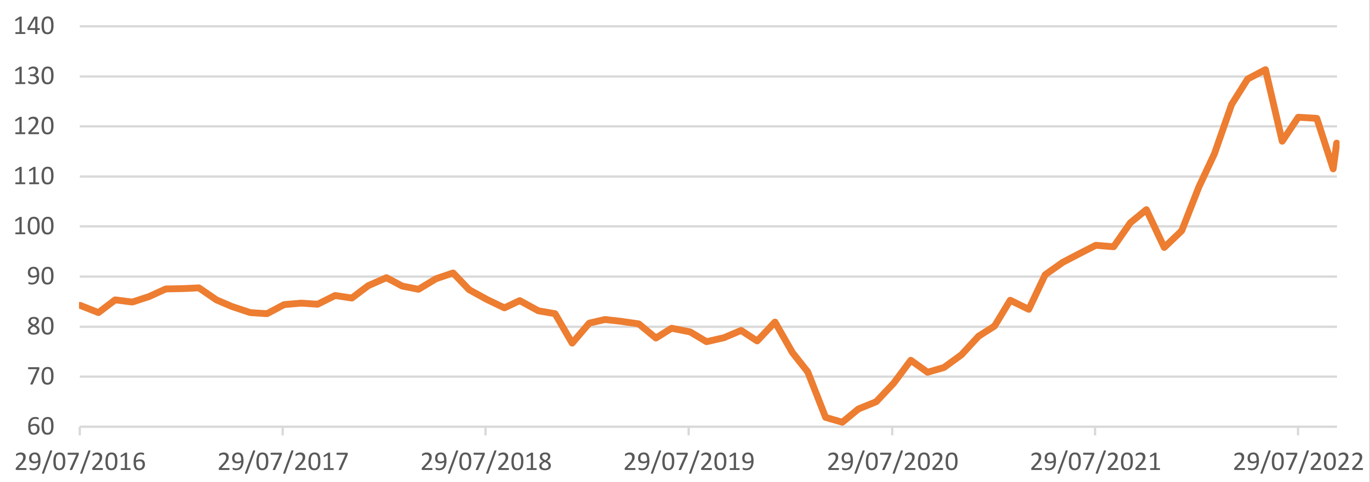


The Dollar may strengthen in the short/medium term, but is well above its average value (as shown by the black line) over a longer time period.

Much of the steam was taken out of the commodities market late in the summer, led by crude oil falling over 30% from its $112 summit, and this was a big part of the reason that an equity rally was seen in July/August. Sometimes higher commodity prices, especially energy can be the sign of a growing economy (i.e. demand-driven), but as we know the current elevation is being largely driven by supply-side constraints and fuel disruption caused by the Russian aggression in Ukraine. At the time of writing Crude appears to be heading towards $100 a barrel, as OPEC discusses more output cuts, and with core inflation proving stubborn this would be an unwelcome development for markets and for consumers. Industrial commodities, as seen this year, are a good a hedge against inflation as any and we advocate holding some exposure (if possible) in an investment portfolio. While they can be volatile in the short term, there is a clear rush by many nations to become energy self-sufficient following Covid and Ukraine/Russia, and while simultaneously many developed countries are attempting to transition to renewable energy over the next few years, they will need traditional fuels and other metals in abundance in order to do so. With commodities currently decoupled from equities in terms of correlations, it makes sense to hold some for diversification reasons alone. Precious metals, in Dollar terms, are in the red year to date but at least have held up better than bonds, and for non-USD investors have been a useful diversifier when all else has fallen. In the short term while rates are still rising Gold will likely languish due to it being non-income paying, but as the cycle turns it may once again shine if the Dollar falls from its peak and rate cuts once again become a possibility.

Finally a note on crypto currencies, which have disappointingly not provided any shelter or diversification benefit for multi asset investors in 2022. Indeed the bitcoin correlation with the Nasdaq index has been well above 0.5 - and although lately there have been some signs of bottoming it is hard to make a case for it from a portfolio construction perspective.

Commodity Index



Commodities have been trending down since the summer of this year, but need to retrace further if inflation is keep falling.

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