BANQUE HAVILLAND

Q2 2023 OUTLOOK

APRIL 2023

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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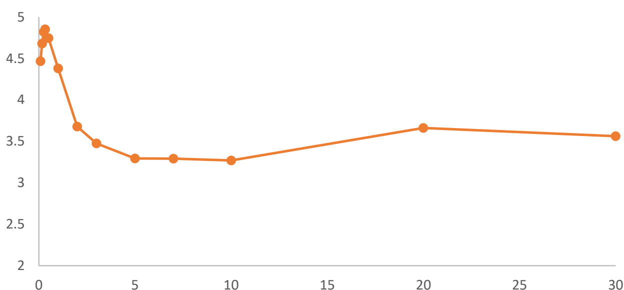
MARKET ENVIRONMENT

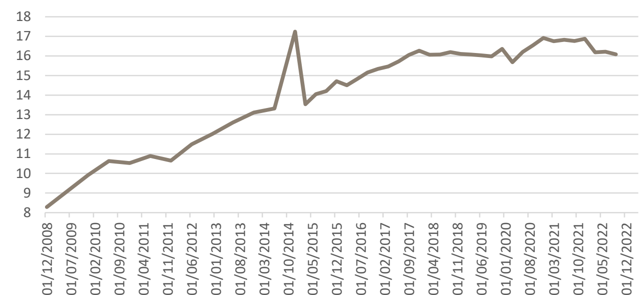
The annals of time may show that the March 2023 turmoil in the banking sector, that culminated in the collapse and enforced takeover of Switzerland's second largest bank was indeed am isolated series of events that did not evolve into anything especially damaging for financial markets, for this is certainly how equity markets in particular have reacted thus far. On the other hand, we have been concerned for some time about the unseen tensions simmering below the surface of the global economy as interest rates have been hiked at record speed from a long period of very accommodative levels, and that the implosion of two tech-focused American banks and then Credit Suisse represent early manifestations of these tensions. Investors can take some comfort from the undoubted specific weaknesses of Silicon Valley Bank and Credit Suisse that made these two organisations particularly vulnerable to flighty depositors, meaning that the system as a whole is not necessarily tarnished. Deposits at SVB were concentrated in a very narrow set of clients with large cash holdings that were not protected by federal deposit insurance, and the bank had overexposed itself to long dated bonds and found itself underfunded when rates climbed so quickly. Likewise, confidence in Credit Suisse evaporated after a never-ending catalogue of mishaps and scandals in recent years that marked it out beyond its global competitors. Nevertheless, recent developments have shaken confidence and macro fundamentals are also showing signs of weakness so while these incidents have been somewhat idiosyncratic, they have broadly been caused by the effects of higher rates, such as mark-to-market investment losses and bank deposits moving in the search for higher yields. As the quantity of reserves falls, the ability of banks to make loans also declines resulting in a tightening effect on economic growth that is coinciding with the 'official' tightening being implemented by central banks that is starting to take effect on the system. Banks are far better capitalised than they were in 2008 when they were at the root of the economic turmoil then, but it is surely not just the banking sector that will experience stress in the new high-rate environment, and it seems inevitable that further shocks are to come, as heavily indebted consumers, businesses and economies are faced with far costlier credit conditions much earlier than they anticipated.

US Treasury Yield Curve



The yield curve is deeply inverted which has historically preceeded a recession - we don't believe equities are priced accordingly.

Tier 1 Ratio Domestic Banks, Eurozone %

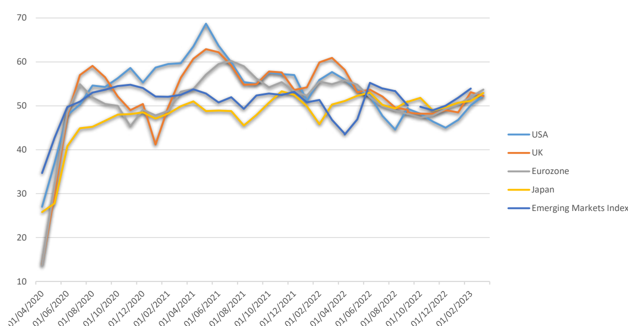


Capital ratios in European banks are double what they were in 2008, meaning they are much better protected against credit shocks this time.

Conventional wisdom is that banks tend to do better in times of higher rates, but with yields on shorter-dated bonds currently higher than those with longer maturities, money-market funds are proving very popular with investors and depositors who are moving their cash away from banks into such products. This could lead to tighter credit conditions for all as banks looks to lend less (with fewer deposits to use as collateral) or charge customers more to make up for the higher rates they need to offer to compete with the money-market funds.

While global growth expectations are increasingly less adverse than a few weeks ago, it is difficult to find signs that either the equity market or the bond market are yet realistically pricing in the prospect of at best a stagnating period of growth, let alone a painful recession. Corporate earnings look set to be no better than 2022's, with valuations yet to reflect this and core inflation (while declining) remains higher and stickier than central banks would like. The chances of a Fed 'miss-step' one way or another looks very likely, with an early end to the tightening program potentially allowing inflation to return, while the maintenance of rates at high levels risks pushing the economy into recession.
Perhaps it will be the real estate market that is next to experience strains caused by tighter financial conditions, or another 'credit crunch'

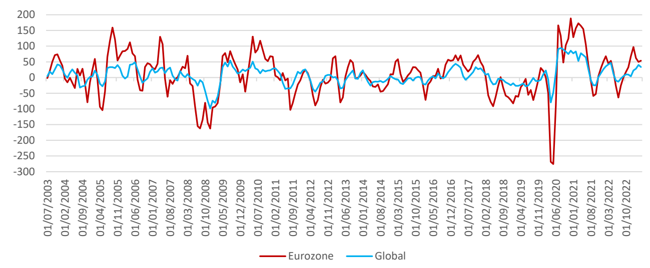
Composite PMI Readings



Purchasing Manager's sentiment are globally a source for optimism, and support the theory that the global economy will not enter a deep recession this year.

as there are already early warning signs of this in the falling prices of major REITS in the US and Europe. The US$3tn commercial real estate market is a sector that is heavily represented on the balance sheets of small regional banks (such as SVB) with vacancy rates currently high and delinquencies on the rise, in a market that has never fully recovered from the pandemic lockdowns (fewer people working in offices). There have so far been a small number of loan defaults in the commercial real estate space, but history shows us there is often a lag between peaking interest rates and defaults so this will be a space to watch closely for signs of more widespread financial stress.

Citi surprise Index

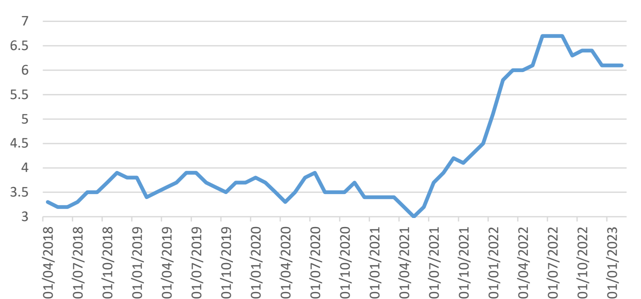


The Citi Economic Surprise Indices measure data surprises relative to market expectations. A positive reading means that data releases have been stronger than expected and a negative reading means that data releases have been worse than expected.

While a likely tightening of credit conditions coupled with an elevated period of interest rates does not bode especially well for risk assets, we are more than aware that markets can remain detached from macroeconomic fundamentals for very long periods, and therefore being underinvested can be very costly. Currently it would seem that equity markets are primarily being buoyed by the expectation of lower rates starting in June, following the banking sector wobble, which we believe is a little optimistic considering central banks stated focus of inflation. That the current rally is being driven by interest-rate narrative over and above all else is indicated by the outperformance of US tech, with the Nasdaq enjoying its best quarter since 2020 – this looks more like dip-buying, than a genuine expectation of an improving

Ostensibly, it seems to us that this dip-buying has been stretched further by way of a relief rally that the banking scare of early March appeared to be over. We think that the belief of the market in a June Federal Reserve rate cut is misplaced, taking into account the resolve to curb inflation (which remains 3 times the target rate) and the solid employment and wage growth figures (albeit with some anecdotal large tech industry layoffs), suggest higher prices are sustainable.

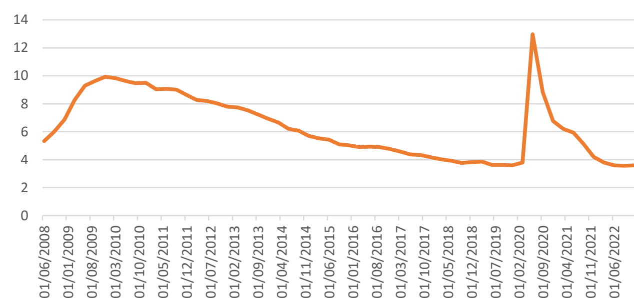
US Wage Growth (Atlanta Fed Tracker)



Though wage growth may have peaked it still remains robust, keeping the pressure on central banks to curb inflation.

One reason for inflation to hang around for longer than markets are expecting may be the unwillingness of companies to relinquish their profit margins to pre-pandemic levels. Many will have raised their margins during the Covid years in response to the supply-chain disruption (stock analysts' much-vaunted ability to 'pass-through' costs to customers), but have not subsequently adjusted them to reflect the now lower input costs.

US Unemployment %



Unemployment figures are still low, giving the Federal Reserve less room for rate cuts.

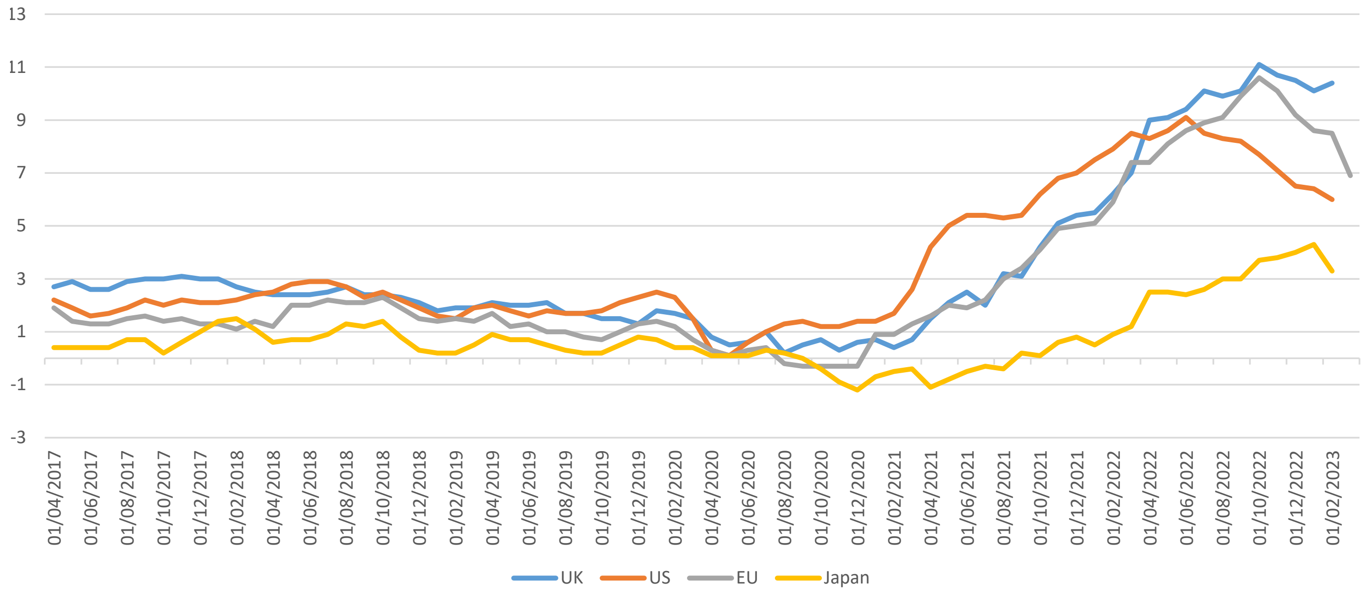
> *"While a likely tightening of credit conditions coupled with an elevated period of interest rates does not bode especially well for risk assets, we are more than aware that markets can remain detached from macroeconomic fundamentals for very long periods, and therefore being underinvested can be very costly."*

In Europe, the economic prospects of the region have been helped by the falling energy prices, and the data has improved to the extent that recessions may now be avoided in the UK and Eurozone. This is cause for some optimism, though we would like to see a clearer reflection of the underlying fundamentals in the financial markets before being confident enough to add further risk to clients' portfolios.

Eurozone Money Supply growth rate, %

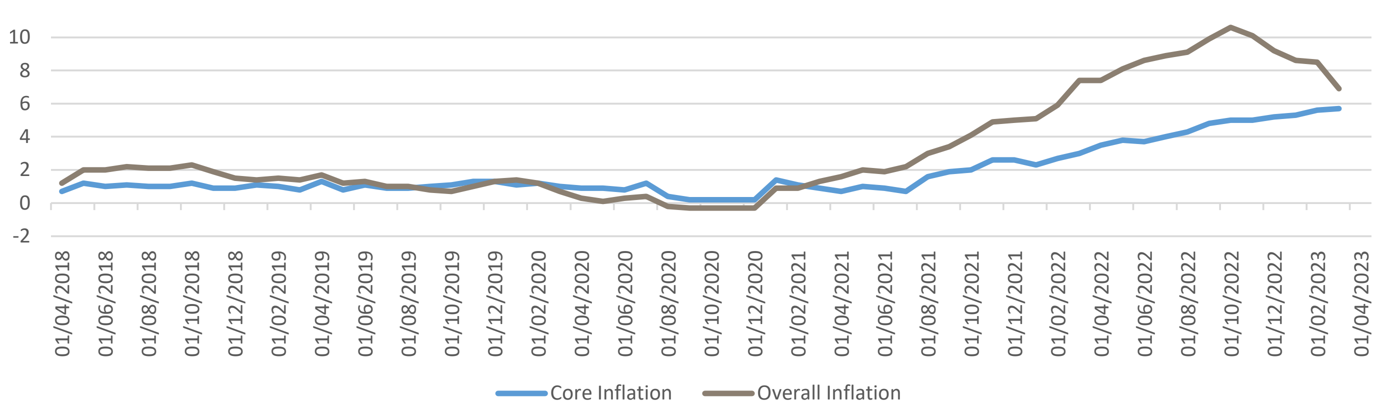
The total amount of money in circulation in Europe has drastically fallen - this points to tightening financial conditions alongside higher ECB rates.

Inflation (year on year) %



Global Inflation levels are generally showing signs of peaking, but remain well ahead of Central Bank targets.

Eurozone Inflation



While overall inflation is falling, core inflation (excluding energy and food) continues to climb. This suggests that the ECB will not look to slow rate hikes until this starts to fall away.

EQUITIES

As already stated we are largely of the view that the rally in equities year to date has been fuelled more by sentiment as based on fundamentals, with markets seemingly priced for only a mild recession and an orderly end to inflation. Despite rapid rate rises and pockets of acute stress in the banking sector, they appear to be expecting only a modest downturn and earnings expectations are behaving as if the recession is already behind us. Indeed Forward earnings have been rising, to the point where the real earnings yield is now positive again, and as we know, this is often a bearish sign with higher expectations more susceptible to disappointment – historically earnings are a lagging indicator and typically don't start falling until after the downturn has begun, similarly forward earnings often only begin to rise once the recession is underway.

Following each case of major recession in 1990, 2001 and 2007 corporate earnings have dropped to varying degrees following the start of the downturn though often the lag is around 6 to 12 months and it is likely that we are approaching this if Q1 2023 turns out to be the start of the latest earnings recession as suspected. Furthermore, equities appear to be oblivious to the stress apparent in the fixed income markets - not only the startling whipsawing in price action that took place in Treasuries in recent weeks, but also that all major yield curves remain heavily inverted. We know that there is a strong relationship between the maximum inversion of the yield curve before a recession, and the peak-to-trough fall in equities, so with many regional indices still elevated following the January rally it would seem stocks are vulnerable.

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EQUITIES				**Despite the banking crisis and the deteriorating fundamentals most equity markets have enjoyed a strong first quarter. An earnings recession amid stickier inflation warrants caution.**
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 to earnings revisions.
UK				British stocks are still very cheap compared with other markets, and the energy/mining component of the 100 is attractive. Bleak political/economic backdrop.
Eurozone				Region is grappling with high inflation and energy prices but this has been offset by the China reopening and a mild winter. Energy and financial stocks look the best value.
Switzerland				Quality, defensive nature of the market continues to see Swiss stocks in demand, though valuations relatively rich now.
EM				We retain an allocation to emerging Asia for the long-term growth potential, with China's reopening finally here. Most EM regions do not justify their risk premiums.
Japan				Attractive valuation for a developed market, with a lower yen supporting its export sector. Economy currently slowly 'reopening' from Covid.

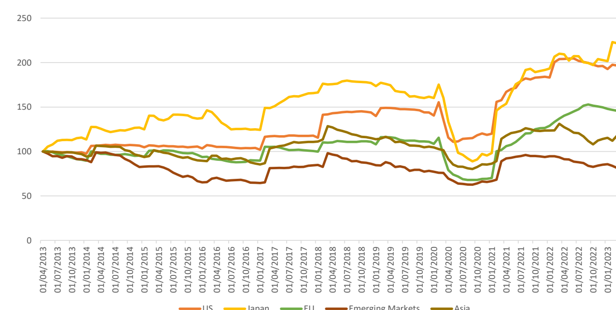
With respect to US equities in particular, we would like to see the yield curve steepen (or normalise) as a pre-condition of a buying opportunity. European stocks have been outperforming this year as both continental and UK companies posted positive earnings revisions last month, while the US and emerging markets stayed negative or flat, and indeed the 12-month forward EPS growth is holding up better than the US Index. Given this recent strength we are not convinced European equities can maintain this market leadership as once the bonus of (lower than expected) fuel costs and the reopening of the Chinese economy are fully priced in by markets (for example European luxury names touching all time highs), there is little to set Europe apart from the US. Having said this the region's financial sector is likely to hold up better than its US counterpart given European banks' higher capital and liquidity cushions. Eurozone small cap companies could represent one of the very few pockets of value, with that segment trading at a historical discount compared to large caps. With core inflation in the region still elevated there will be further ECB rate rises to come which will increasingly tighten credit conditions.

It is a brave investor who bets against the US equity market, with its traditionally robust and dynamic economy, though once again the market seems bifurcated with virtually all the heavy lifting in terms of performance coming from the tech sector and the global mega stocks such as Amazon, Microsoft and Alphabet etc. While we would not necessarily question the growth and quality of these specific mega-cap businesses, the return of outperformance this year within some of the more 'hopes and dreams' stocks in the tech market does not seem healthy or sustainable – too much optimism is riding on a premature rate cut, that may well not come - or if it does come, may well lead to a low-growth/high-inflation scenario that would see such stocks punished once again.

On the other hand the value rally that punctuated 2022 already seems to have run its course, and the recent price action serves as a reminder of how willing investors seem to favour growth stocks in a bull market – and being too heavily weighted towards any particular style can lead to serious underperformance. As such, our preference in current market conditions is for quality companies that exhibit growth potential while keeping an eye on valuations and debt levels at a time when the cost of debt looks set for a heightened period.

For the first time in a while we don't have any great conviction in terms of regions, and while we understand the consensus rationale for favouring emerging market stocks, it is unconvincing that 'this time will be different' in the event of wider risk-off sentiment, i.e. correlations between developed economy markets and emerging ones have genuinely decoupled. Admittedly China does seem to be a global outlier in this respect, largely due to its delayed but extensive economic reopening after years of draconian restrictions – corporate earnings look to be improving even as valuations move off cheap levels and monetary stimulus is boosting consumer spending of lockdown savings. There is, however, a question mark in terms of a potential reflationary environment. Notwithstanding any great conviction we continue to believe that exposure to global regions other than an investors home market brings multiple diversification benefits, from currency exposure and economic differences to the specific compositions and sector coverage that overseas markets can offer.

Earnings Estimates



Earnings estimates are optimistic and do not appear to expect an economic slowdown. This leaves equities vulnerable to a re-pricing.

BONDS

Following the historically awful year for bonds of 2022, fixed income markets have rallied sharply in 2023 due to the market pricing in an end to one of the most aggressive tightening cycles in the past 30 years, though we have seen some pretty violent moves, especially during March as the mini-banking crisis unfolded. Though there has since been something of a relief rally, caution is still advised when approaching the bond market. Central bank balance sheets and credit growth data will now come under the microscope due to the banking crisis and we remain vigilant for further signs of bank stress and for signs that the economy is decelerating as bank credit tightens. We believe capital markets will return to being sensitive to economic data releases, as both the Federal Open Market Committee (FOMC) and European Central Bank (ECB) have removed all forward guidance, communicating that they are data dependent. Inflation data will be watched most closely; prior to the banking stress, central bankers were not convinced that enough tightening was in the system to alleviate inflationary concerns. The recent inflation data released out of Europe and the US somewhat validated their concerns as UK and German inflation actually rose while Eurozone core inflation (the ECB's preferred metric) also ticked up. In the US high core services inflation is keeping overall inflation sticky. Core services inflation is particularly sensitive to the higher wages that private sector firms are offering as they face difficulty filling vacancies – this does not generally point to an ideal environment for fixed income assets. Nevertheless, we need to remind ourselves of a little over a year ago when yields across the asset class were so paltry it was difficult to find value anywhere in the bond market – at least now there are 5% yields on offer for a good number of quality investment grade issuers. As it stands we would suggest that Investment Grade short duration debt in the 2 year maturity bracket looks like the only truly attractive part of the market, as elsewhere there are concerns: yields on US Treasuries have fallen sharply as markets have rushed to price in the prospect of aggressive interest rate cuts from the Fed to shore up the financial sector, but this looks like an overreaction and not consistent with the Fed's own narrative – a cut in the summer is improbable. For our duration outlook to change we would need to see a deterioration in economic conditions whereby longer dated Treasuries may rise, but as it is the inverted yield curve does not look conducive for maturity risk. We prefer US Treasuries to European government bonds due to the need for further hikes by the ECB in the face of inflation, plus the banking situation looks more secure than in the US, so further financial sector weakness will be less of an obstacle to tightening policy. We highlighted in our last outlook how the loosening of yield-curve control by the Bank of Japan that may eventually lead to outright tightening was a slow-burning threat to the low yielding Japanese bond market, and indeed may have ramifications for other markets and this is something we continue to monitor closely as the new governor takes his position.

“(...) we need to remind ourselves of a little over a year ago when yields across the asset class were so paltry it was difficult to find value anywhere in the bond market – at least now there are 5% yields on offer for a good number of quality investment grade issuers.”

In the credit markets, US High Yield debt has enjoyed a strong start to the year, gaining more than 4 per cent since January in a rally that saw high yield credit spreads tighten by around 80 basis points, however fundamentals are slipping and junk bonds are most susceptible to corporate debt problems that may arise late in the credit cycle. We also note that troubles are more and more visible in the CMBS space, and we reiterate our worry for real estate credit-linked securities.

A very selective approach can benefit portfolio in terms of enhanced yield pickup, but investors should approach with caution. Local currency emerging market debt looks appealing as we think the Dollar should weaken later in the year and as many EM central banks are providing stimulus while raising rates and we believe that a short duration approach is a better risk-adjusted way of accessing yield in these markets.

2 Year Bond Yields

COUNTRY	YIELD + / -
BRAZIL	4.60
NEW ZEALAND	4.53
MEXICO	4.17
UNITED STATES	3.78
CANADA	3.57
BRITAIN	3.31
FRANCE	3.31
SOUTH KOREA	3.23
ITALY	3.04
GREECE	3.00

COUNTRY	YIELD + / -
AUSTRALIA	2.83
SWEDEN	2.74
SPAIN	2.73
GERMANY	2.50
PORTUGAL	2.46
NETHERLANDS	2.46
CHINA	2.35
SWITZERLAND	0.91
JAPAN	-0.06

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FIXED INCOME								**Yields are far more attractive than a year ago, but it is unclear whether a period of structurally higher rates and inflation is yet priced in. The far end of the curve is vulnerable to steepening.**
Sovereign Bonds								US yield curve is inverted and rates remain under threat while inflation remains elevated. Recession may see some support, but not until FED expectations peak.
Corporate I.Grade Bonds								Buyers may soon come back with 5% yields for corporates looking attractive against a recessionary backdrop. US looks preferable to Europe.
High Yield Bonds								Default rates are subdued, but may rise as financing costs increase. Yields look attractive, but highly selective approach needed.
E.M. Bonds								We are generally cautious on emerging markets given looming recession fears, but our short duration approach achieves yield at acceptable risk.

CURRENCIES AND COMMODITIES

Should central banks stick to their expected trajectories in the coming months then accordingly the world's major currencies should, all else being equal follow similar paths. Therefore we currently expect to see general USD weakening towards the end of the year as the Federal Reserve complete their hiking cycle (expected to be around 5 – 5.25%), while the ECB and Bank of England catch up to some extent as inflation remains more elevated in Europe.

Away from rates, there also seems likely to be a continued unwinding of the Dollar strength that occurred from mid-2021 to the summer of 2022 towards more historically average levels, as the need for Dollar funding passes. This is, of course, unlikely to be a smooth path as any shocks or bouts of volatility in financial markets will see the usual flight to liquidity and safety that will see flows into the reserve currency – and as already stated, we expect more of such shocks as the higher rate regime squeezes the vulnerable parts of the economy. The determination of central banks to quell inflation, potentially at the expense of economic growth, should not be underestimated as they seek to avoid the mistakes of previous generations, and the recent surprise 50 bps hike by the Bank of New Zealand despite the faltering economy is a good example of this. Time will tell if the Swiss Franc can retain its lustre as a safe-haven following the knock to the reputation of its banking industry, and in the short term the SNB is unlikely to risk further instability by raising rates so the outlook for the Franc is not especially bullish.

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CURRENCIES								**Dollar demand returned amid the March banking crisis, but DXY looks set to slide as the Fed nears the end of it hiking cycle and other regions' policy makers catch up.**
U.S. Dollar (DXY)								The dollar is only likely to retreat further if a lower inflation trend is confirmed and FED becomes more dovish. Likely to be underpinned by relative resilience of US economy v Europe.
Sterling (GBP)								A period of political calm and a hawkish BOE are supporting the pound, with recent data better than feared. A potential higher tax regime may stifle competitiveness.
Euro (EUR)								Has rallied on ECB hike, China and sticky inflation. Economy looks vulnerable to consumer squeeze and ECB will be wary of hiking too hard in face of recession.
Japanese Yen (JPY)								JPY has potential to breakout when BOJ loosen curve control. Domestic economy is strengthening, but will Kuroda loosen before his successor takes over.
Swiss Franc (CHF)								CHF remains relatively steady despite CS debacle. Chances of an SNB hike unlikely now though.
EM								CNY will benefit from economic pick-up in China, while other EM's will enjoy carry from and long term USD weakness.

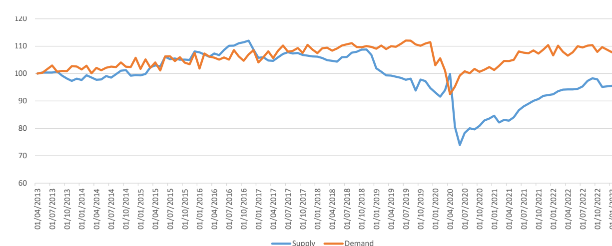
Were we to pick a currency that has the potential for the greatest rally over the long term, it would be the Japanese Yen due to tentative signs of a more hawkish tone emerging from monetary policymakers - there is growing pressure on the Bank of Japan to pivot away from ultra-easy monetary policy, not least in dropping its yield curve control measures, which would allow rates to rise along with JPY. Coming off the back of many years of ultra-low rates and stimulus, however, we expect this process to be extremely measured and drawn-out – pointing to a slow appreciation of the Yen.

US Dollar Index (DXY) over 5 years

We think the Dollar will continue to fall back to lower historical average levels as other central banks close the gap on the Fed.

Commodities have been enjoying a strong revival in recent years, with broad commodities returning 27% in 2021 and 15% in 2022.A combination of fiscal and monetary support in the early phases of the COVID-19 pandemic helped to soften the damage to demand from one of the deepest economic shocks in modern times. As COVID-19 restrictions lifted, commodity demand bounced back strongly, and then the Ukrainian invasion presented a supply shock, restricting energy and agricultural product supplies and further supporting commodity prices. Whilst many developed world central banks tightened monetary policy in the first half of 2022, inflationary pressures became the most extreme since 1981 and supply chains could not keep up. Currently the outlook for commodities is clouded by the cyclical uncertainty, with concerns of a recession curbing demand being weighed against a Chinese economic surge that should see industrial demand for imports. The longer term outlook for commodities, is (we continue to believe) structurally strong with the 'transition to net zero' being pursued aggressively by many governments - metals are critical for the manufacture of batteries, electrification of power energy consumption, electrolysers, heat pumps, and other technologies needed for the energy transition. We also note that several commodity curves are still in "backwardation" meaning there is a positive roll yield for financial investors. International Energy Agency data indicates that, in a net zero emissions scenario, supplies of critical materials are going to be woefully short of demand, both in terms of mining and material production. In the US, a raft of legislation, not least the Inflation Reduction Act (IRA) will see a total of $370 billion spent on various clean energy initiatives that will see huge demand for infrastructure projects, while the EU's REPowerEU plan will require €210 billion of energy infrastructure spending in order to transition away from Russian hydrocarbons. Crude Oil has been trending lower as fears of an economic slowdown have crept in and the mild winter has seen demand muted as we move to a period of seasonal weakness for energy prices, though the recent actions of OPEC in cutting production served as a reminder that the market can always be caught out. A floor of $70 a barrel looks set to hold for some time.

Oil: Demand is beating Supply = higher prices



Demand for crude remains historically higher than supply, indicating support for the medium/long term oil price.

Gold Spot price $

The Gold price is at record highs following the banking sector turmoil and could go further if rates have indeed peaked.

AUTHOR

Jonathan Unwin
Asset Management & Advisory
15 years' experience of multi-asset-class investments, including 8 years at Credit Suisse and Saxo Bank, London prior to Havilland. Jonathan is the Chairman of the banks' Investment Committee and the lead manager of the Managed Fund and Investor Visa portfolios. LLB (Hons) Law, University of Southampton. Chartered MCSI.

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ASSET MANAGEMENT TEAM

Stefano Torti
Group Head of Asset Management & Advisory

Teemu Riihijärvi
Deputy Head of Asset Management & Advisory

Ronak Yadav
Senior Investment Advisor, Asset Management & Advisory

Thomas Mcleod
Assistant Portfolio Manager, Asset Management & Advisory

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BANQUE HAVILLAND S.A.
35a, avenue J.F. Kennedy | L-1855 Luxembourg
t. +352 463 131 | f. +352 463 132 | e. info@banquehavilland.com

BANQUE HAVILLAND S.A. (UK BRANCH)
5 Savile Row, London | W1S 3PB | United Kingdom
t. +44 20 7087 7999 | f. +44 20 7087 7995 | e. info.uk@banquehavilland.com

BANQUE HAVILLAND (MONACO) S.A.M.
Le Monte Carlo Palace | 3-7, Boulevard des Moulins | MC-98000 Monaco
t. +377 999 995 00 | e. info.monaco@banquehavilland.com

BANQUE HAVILLAND (LIECHTENSTEIN) AG
Austrasse 61 | LI-9490 Vaduz
t. +423 239 33 33 | e. info.lie@banquehavilland.li

BANQUE HAVILLAND S.A. REP.OFFICE (DUBAI)
Aspin Commercial Tower | Office # 4001 | Sheikh Zayed Road
P.O. Box 414678 | Dubai, United Arab Emirates
t. +971 4 306 28 88 | e. info.dubai@banquehavilland.com

BANQUE HAVILLAND (LIECHTENSTEIN) AG, VADUZ, ZWEIGNIEDERLASSUNG ZÜRICH
Bellariastrasse 23 | 8027 Zürich | Switzerland
t. +41 44 204 80 00 | e. info.switzerland@banquehavilland.ch

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