BANQUE HAVILLAND

Q3 2023 OUTLOOK

JULY 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

At the halfway point of the year the balance of economic forces still appears tilted against global capital markets, and yet both markets and many major economies have remained resilient with growth positive and earnings results largely better than expected. There are plenty of reasons to be cautious, not least sticky inflation, central bank tightening and stresses in the financial sector as well as the unevenness of the equity rally to date. Having said this the expected coming economic slowdown has been especially well anticipated so a great deal of caution is already holding back many investors, suggesting any negative market reaction to future weakness may be muted. While a combination of still-high inflation and low real GDP growth is neither desirable nor sustainable longer-term, even with a pause in the very near-term, the path of least resistance for markets may be up, and recent years have shown us that sitting on the side-lines waiting for cheaper entry points can be an expensive. While we have been waiting for (amongst other things) a recession to arrive, interest rates to peak, a resolution to the US debt ceiling debate and for the valuations of growth equities to resemble normalcy – the US Nasdaq Index is up 30%, European stocks are up 15% and Investment Grade bonds are up over 4% in 2023 so far – highlighting the folly of being underinvested for any great length of time. Excessive pessimism can lead investors to overlook opportunities and miss market recoveries and whether economies and markets can continue to defy the pessimists in the second half of the year is the major theme for investors to chew on throughout the summer.

At any given time there will be risks to investing, and it is therefore important to distinguish nearer-term dynamics from longer ones, and between risks that can be managed and those that can't really be avoided. The well-documented, extraordinarily narrow market leadership being seen in US (and therefore Global) equities is perhaps an example of where risk can be managed, if not altogether avoided. The boom in a selective group of US mega-cap stocks has been driven by a wave of optimism concerning the future impact of Artificial Intelligence (AI) on the global economy, with those companies seen to be the early players in the AI revolution rising extremely disproportionately from the rest of the market.

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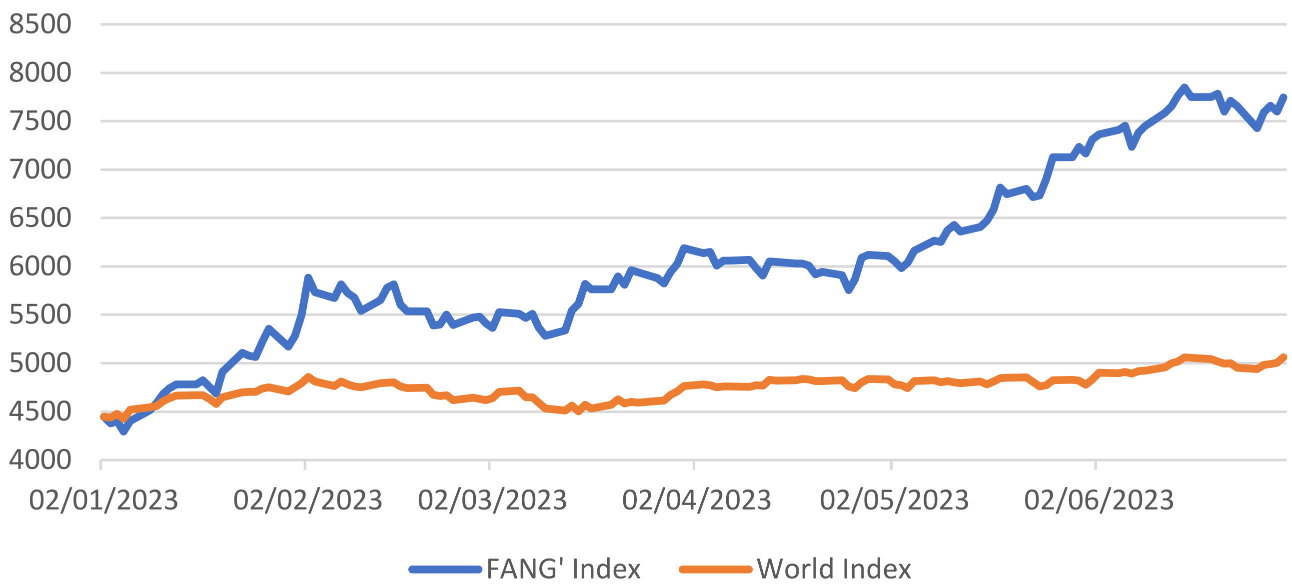
Indeed, once the performance of NVIDIA, Microsoft, Apple etc has been stripped out of the year to date figures, the returns of the wider market look far less impressive – never has the market cap weighted indexation method so heavily distorted the link between economic reality and stock market returns! Any investor in global equities who does not have a heavy exposure to these high-profile growth stocks will have no chance of keeping up with headline index returns, let alone outperforming, no matter how overweight or underweight compared to any benchmark they are. While this can be disconcerting, circumstances such as this is why we have always advised people not to preoccupy themselves with benchmark performance but rather focus on their own perceptions of risk and return. In terms of risk management then, we have a long held philosophy of avoiding bubbles and the extreme valuations that such market environments produce. The 'Magnificent Seven' stocks (in order of market cap: Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta Holdings and Tesla) actually account for 100% of the US 500 Index's 14% returns year to date, (meaning the other 493 companies have on aggregate contributed nothing) and are now approaching extreme levels once again, having seen significant re-ratings in 2022. Apple has recently become the first company to reach a market cap of $3 Trillion! NVIDIA, the current darling of the AI hype, is now trading with a Price Earnings ratio of 200x and price to sales ratio of 25x 2023 sales, and brings back memories of certain market sectors in late 1999's tech bubble. While it can be frustrating to not be participating in such a rally, we remain of the belief that a balance across equity styles: growth, value, cyclical and defensive, is a more responsible way to preserve and grow our clients' wealth over the longer term, and as such some of the seven companies will indeed feature in client portfolios if their quality, valuation and long term prospects justify it (e.g. Alphabet), but not if they don't (e.g. NVIDIA). Logically, as there are surely plentiful bargains among the 493 other stocks in the US index, there are better regions to look to than the relatively expensive US market itself and our approach to seek out attractively-valued, but unfashionable markets at times when others are looking elsewhere is paying off, as shown by our early Japanese equity allocation before it became a more consensus option. Our 'cautious but invested' approach means that we are holding neutral weights in equities and bonds for client's portfolios, but with a very selective and focused selection of global investments.

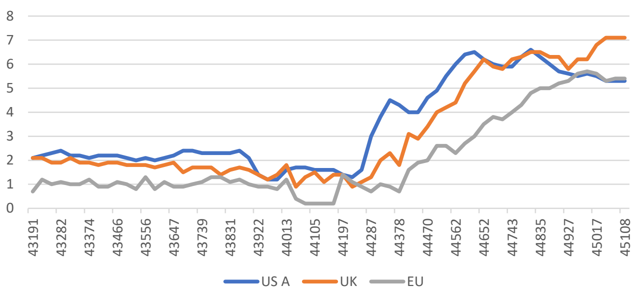
Outperformance of Tech Mega Cap 2023



The FANG+ mega cap index has outperformed the rest of the world by over 60% ytd, so any strategy not fully invested in this handful of stocks will appear to be underperforming.

Perhaps the wider deterioration of the economy in the face of a relentless series of central bank rate hikes is an example of a known risk that is harder to simply diversify away or avoid. While the markets and economies have remained resilient to date, seemingly looking beyond the current 5% base rate to the prospect of cuts later in the year, we are concerned that inflation is not yet fully under control with CPI in the US still well over twice the Fed's desired level, and still over 6% in the Eurozone – with higher rates still to come from the ECB and Bank of England. Core inflation readings - which exclude volatile food and energy prices - remain stubbornly high. While the global growth outlook is positive once again, it is expected to be modest at best and the danger is that a period of tighter credit conditions could derail this growth, and the lag effect of higher rates has yet to meaningfully feed through into the economy. Furthermore there is still a disconnect between the Fed's stance and what the Fed Funds Futures market is assuming with former indicating a base rate of 5.6% for 2023, but futures expecting 5% and falling by the end of year – the scope for financial markets being forced to correct their assumptions is therefore high.

Core Inflation



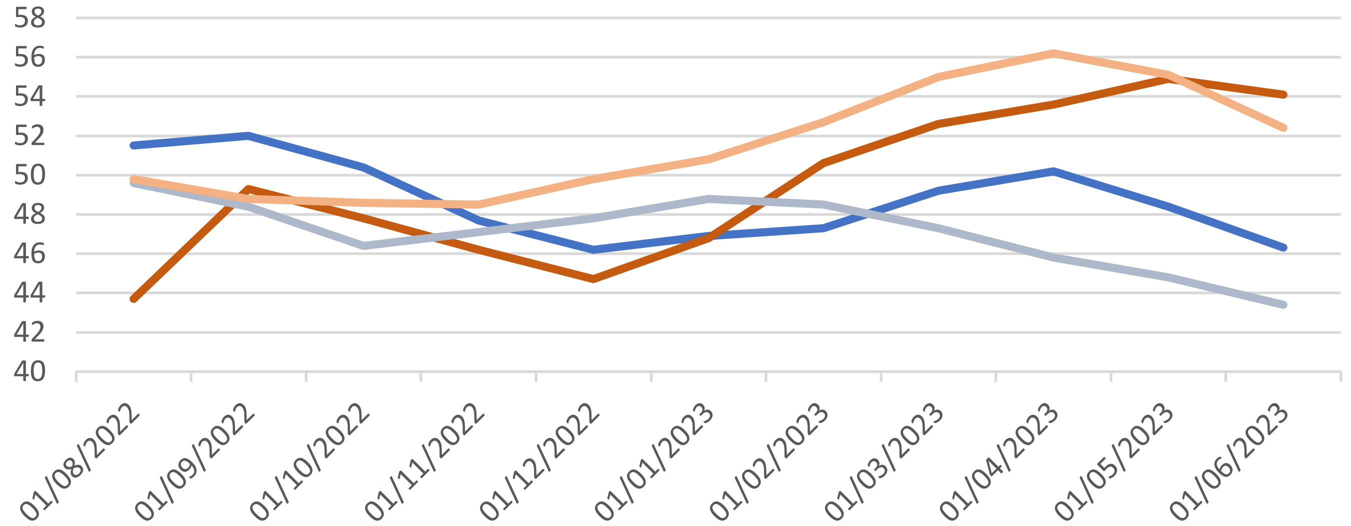
While headline CPI has peaked, core inflation (exlcuding energy and food prices) which the central banks focus on, remains elevated.

Near term rate-hikes in Europe are even more unlikely, with both the BOE and ECB maybe needing to hike further despite the economic risks, while all eyes remain on the Bank of Japan who remain an outlier among developed central banks by still being in quantative-easing mode.

Should the BOJ lift its' yield curve controls (i.e. start tightening) this could have significant effects on the world, with Japan such a major component of the global economy and if Japanese investors start repatriating much of their offshore wealth. Should rate cuts not arrive as soon as markets expect, we could well see the disappointment express itself in terms of asset prices.

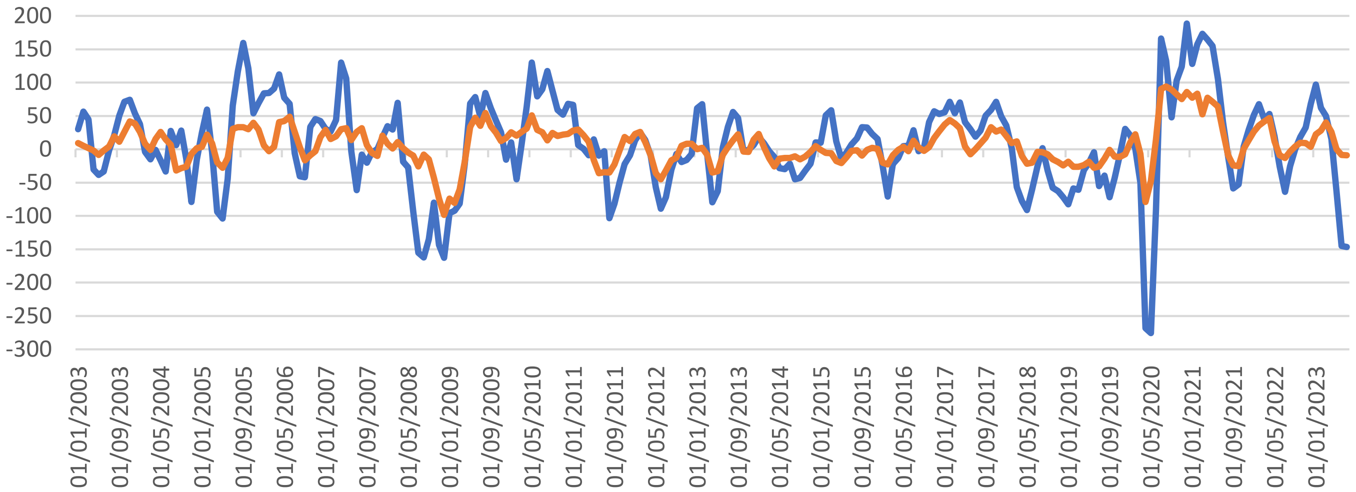
Aside from the sticky core inflation outlook that is clouding the picture for interest rates, other macro data is also mixed. Forward-looking sentiment indicators such as Manufacturing PMI's both sides of the Atlantic are well below 50, which points to pessimism, though the services PMI are both more positive. Employment remains strong more or less universally which is giving central bankers a headache but payroll growth has continued to decelerate, companies are cutting hours, and inflation sectors that have been stubbornly sticky, such as rental inflation, finally seem to be peaking. Chinese economic growth, so often relied upon by markets in recent years now seems to be stalling, as the great reopening after the three years of pandemic lockdowns has somewhat fizzled out. It may be somewhat premature to call the end of the Chinese growth miracle but sentiment among investors has soured quickly over the past few weeks as Consumption is weak, investment is faltering, stimulus is ineffective, exports are slowing and private-sector confidence is frail. Long-term structural growth challenges (like demographics and an overleveraged property market) are also apparently suppressing demand, and in the past we would have expected the Chinese government and central bank to step in decisively, but worryingly the lack of reaction to June's rate cut suggests this time it may not be enough. There are hopes that Japan can pick up some of the slack, however, as a weak yen is helping boost Japanese exports and the economic outlook there is looking promising, with corporate earnings finally giving reasons for cheer.

Purchasing Managers' Index



PMI data appears to be ticking downwards, though Services and Manufatcuing outlooks are diverging. Manufacturing data is already well below 50 - indicating economic contraction.

Citi surprise Index



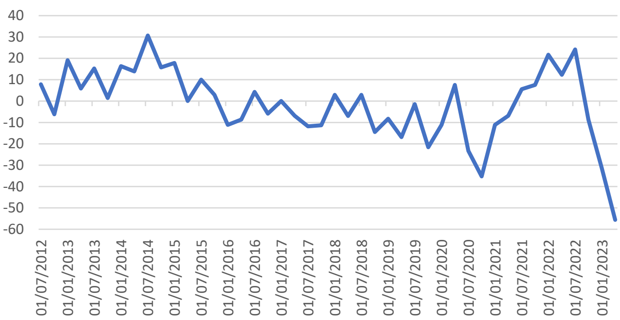
The Citi Economic Surprise Indices measure data surprises relative to market expectations. A positive reading means that data releases have been stronger than expected and a negative reading means that data releases have been worse than expected.

High debt levels are also providing a background of uncertainty, being at all-time highs and the recent debt ceiling standoff in the US is both a symptom and reminder that the status quo is not sustainable in the long term.

The expedient resolution to avoid the debt-ceiling of course merely kicked the debt can down the road and did nothing to assuage the underlying problem of the US and the world living beyond its means – fortunately for the US the Dollar is the world's reserve currency and Treasuries considered the least risky asset in the financial system, so while this remains the case the debt issue will likely be delayed indefinitely.

It may be an extreme (but not totally inconceivable) scenario to imagine a US default at some stage in the future, but this would require the demise of the Dollar in order to happen. Higher rates make the cost of servicing and renewing this debt more expensive and already there are signs of a growing credit crunch exacerbated by the stress in the US banking sector – although the major banks showed a clean bill of health recently and even if no further smaller banks go bust, there are likely to be ripples felt from those that did earlier in the year as fewer lenders means tighter liquidity and less credit available.

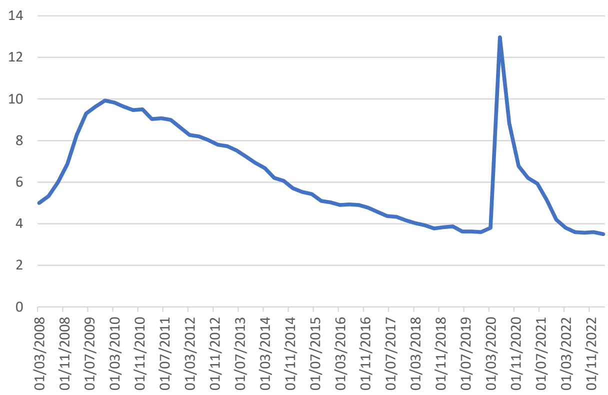
US Senior Loans Survey



% of respondents reporting demand for commercial and domestic loans.

It is possible that this tightening has yet to be felt, and the more lightly regulated 'shadow banking' system including real estate lenders and commercial loans will feel the strain most. The most recent Senior Loan Officers Survey highlighted loan standards tightening and demand for new loans correspondingly weakening – at its lowest since 2009. Finally, we note that the major yield curves remain inverted and have been for some time – a historically reliable precursor to recession albeit over an uncertain time scale, and some investors are even saying that 'this time is different' regarding the relationship between the yield curve and future growth, but we think curve inversion remains a valid indicator - recession probability is high. Optimists will point out that a mild recession and disinflation (even at a slow rate) could occur alongside positive earnings growth and weak/modest economic growth – and indeed equities could potentially thrive in such an environment. This is not a sustainable long-term backdrop, however, and we think that the assumption of a significant slowdown and the associated cautious positioning of client's portfolios is still the right approach for now.

US Unemployment %



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

EQUITIES

With the aforementioned narrow market leadership of those stocks associated with the advances in Artificial Intelligence technology being such a dominant theme this year, it would be remiss not to discuss AI in more detail and the implications for investors. Generative artificial intelligence is the hot technology of the moment - it creates new and original content using machine learning algorithms and configurations from existing information and is brilliant at quickly completing certain tasks to a high standard (though still is prone to mistakes). At the moment AI promises an enhanced level of automation and could provide significant productivity gains for companies, especially in terms of process-driven, repetitive roles and tasks, as well as creative tasks such as video games design, movie background development, music production, computer programming and copywriting. Hence, the excitement among investors that is driving prices higher for technology stocks that are believed can provide equity exposure to AI. NVIDIA in particular has been the biggest beneficiary as their semiconductor hardware is the best known at this point. Undoubtedly, investors should be looking to include some AI stock in their portfolios, but as with all decisions they should also consider the risks as well as a price-sensitive approach along with an understanding of which part of the value-chain they are exposed to. While NVIDIA may be a 'pure play' way of investing in the chips that support AI, it is now at extreme valuation levels that makes it vulnerable to any change in sentiment while Microsoft may be a more diversified tech option but whose AI exposure is one revenue stream of many to consider. Even Microsoft, however, is up 40% year to date, much of which is due to the AI hype, while Apple and Google have added tens of billions in market capitalization after NVDIA's bullish May statement so we suspect that the optimism is a little overdone at this point.

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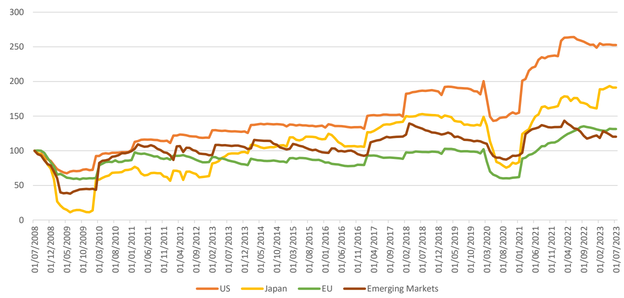
EQUITIES								**Despite the banking crisis and the deteriorating fundamentals most equity markets have enjoyed a strong first quarter. An earnings recession amid stickier inflation warrants caution.**
US								The US tech sector and hype surrounding the potential of AI has dragged the market higher, with most index constituents treading water as recession looms.
UK								British stocks are still very cheap with many companies ripe for takeover. GBP appreciation attractive for EUR, USD investors. Growth revised up, but tepid.
Eurozone								Reasonable valuations and solid earnings outlook are tempered by high inflation and mediocre growth outlook. Germany in recession, but region could benefit from China stimulus.
Switzerland								Quality, defensive nature of the market continues to see Swiss stocks in demand, though valuations relatively rich now.
EM								China looks to receive more stimulus as reopening fizzles out, but this may not transpire into equity gains. Other Asian economies look set to benefit from Western 'friendshoring'.
Japan								Attractive valuation for a developed market, with a lower yen supporting its export sector. Economy currently slowly 'reopening' from Covid. Loose policy remains supportive.

Investors need to be wary of not getting caught up at the wrong end of the ‘hype cycle’ whereby an innovation progresses from innovation to overenthusiasm, through disillusionment, and eventually to an understanding of its relevance and role in a market. Examples of this include Cisco and Nokia who at the turn of the century reached huge market caps at the peak of the cycle only to fall away dramatically and never reach such heights again – and it does seem a lot of hot money has chased AI names over the past year, and much of that is driven by investors seeking exposure to the theme rather than applying a more discerning investment plan to generate long-term returns. Aside from valuation risks, there are wider sector issues to consider that could dampen enthusiasm for the AI theme - as a new technology it is bound to attract closer scrutiny from governments and regulators: this could range from increased protectionism regarding production and supply chains, to enhanced competition restrictions towards the companies involved, as well as political opposition from those who potentially stand to lose from AI advances. Geopolitical tensions could affect the ability of companies and researchers to protect their intellectual property, that could limit the pace of innovation while already some key voices within the tech sector have expressed concerns about the pace that AI is progressing...conjuring fears of science-fiction like threats to humanity. Most investors will simply want to ensure some exposure to an intriguing sector, and we encourage this providing valuations are acknowledged and risks appreciated. Moreover, should the technology develop to become as integral as is currently hoped then well-diversified equity investors will benefit either directly or indirectly as AI involves to become embedded in the global economy – and as pointed out the first movers are not always the best long-term beneficiaries of a new innovation.

In general, the outlook for equities remains uncertain due to tight financial conditions, a slowing economy, and elevated valuations, although valuations outside of US large-cap are more attractive on a relative basis and there enough markets and sectors globally that are cheap enough for us to be comfortable with a neutral weighting despite the fog. We have commented that the US looks expensive at index level with the price/earnings ratio of the US 500 close to the top of its 10-year range, however, the small cap index is near the bottom over the same time scale. We know that the performance and price of the main index is being distorted by the handful of mega tech names that are more global in nature and are riding the AI wave, and so are perhaps more immune to the turgid underlying real economy than the typically more domestically orientated smaller companies. Technology is not only the preserve of large cap companies, and when the sector sold off heavily in 2022, many of the small cap IT firms saw their valuations knocked, but have yet to recover as

Earnings Estimates



Earnings estimates seem to have plateaud, but have a long way to fall in order to be in line wth historical growth levels. This is a warning sign for equities.

some the bigger players have this year – we therefore see exciting opportunities to invest here at attractive entry points.

Our faith in Japanese equities has finally been repaid this year, and it remains a conviction region for us, though this is caveated by a lower JPY which while helping the stock market has taken the edge off performance for EUR and USD investors. Japan has historically been trading cheaply for some time, so without a meaningful catalyst, valuation alone is not a reason to expect outperformance. There is a risk that the long-awaited tightening of monetary policy may come harder and faster than expected, thus curbing growth, but on balance it seems a very slow unwinding process is the likelier direction. GDP in Japan has ticked up as tourism returns to the country after Covid, while inflation is finally showing signs of life – but not to the extent that equities need to be worried. Should inflation leap, the Bank of Japan is starting from such a low base that prices should be capable of being reined in as necessary. The inflation is forcing companies to extend their profit margins and is creating demand for higher wages from Japanese workers, which has traditionally not been the Japanese way – should companies look to automation and efficiencies to enhance productivity this too should benefit equity investors. Conversely, to the west across the East China Sea there are signs that China is rather resembling Japan's 1980's post-housing bubble period of deflation as borrowers away from the central government appear to be increasingly paying down debt following years of credit-fuelled spending – which partly explains why China's economic reopening is underwhelming. China is also losing out as the continued realignment of western supply chains gathers pace, with many companies (including Chinese) relocating manufacturing plants to countries with less geopolitical tensions – Mexico and other 'friendlier' Asian nations such as Vietnam and India seemingly benefitting the most. As such, while we favour some investment exposure to emerging Asia for the growth potential it makes sense to gradually refocus this away from China. European markets (aside from the UK) are still enjoying double digit gains at the halfway point of the year, though we note that nearly all these gains were made in January and since then the index has been ranging and remain below February's high. Further expected ECB hikes are weighing on sentiment for now, with Germany in technical recession and the prospect of a higher EUR affecting the regions exports. With earnings growth set to be negative for the following year, we are not yet ready to allocate further to the region.

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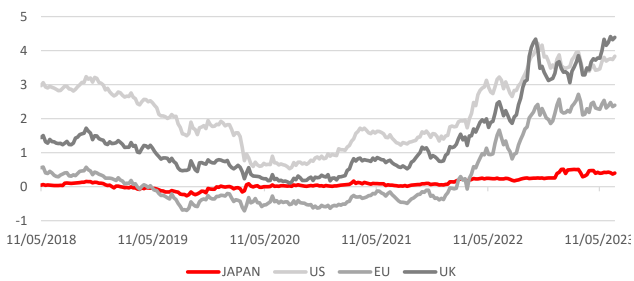
FIXED INCOME

While some way from being actively bullish on the bond market, we are content that many high quality sovereign and corporate bonds are now yielding sufficiently to justify a neutral allocation in the asset class, and should offer diversification and insurance benefits in the case of a deteriorating economic backdrop. With a broad yield of over 5.5% for the US investment grade universe, we think this is a reasonable return after last year's sharp re-rating, particularly at the near end of the curve i.e. in the 1-3yr maturity space where sensitivity to interest rate movements and credit risk is lower. With inflation still elevated much of the global bond market is still yielding negatively in real terms, however, so investors should be mindful of this when looking at bonds as a standalone investment prospect (as opposed to part of a multi-asset portfolio). Our preference for Investment Grade credit is very much at the higher-quality end of the spectrum despite the outperformance of high-yield year to date, as we suspect that the riskier end of the market is benefiting from a postponed economic slowdown and a series of positive data surprises. If and when a recession does transpire then junk debt and lower-credit bonds could be vulnerable and quickly give up the years gains. As ever, a selective and informed approach to high-yield bonds is crucial in order to differentiate between healthy versus true junk balance sheets to minimise default risk in tougher times. We think bond investors can take comfort that today's investment grade and traditional high yield market are much higher credit in terms of overall credit quality than they have been in the past, particularly the high yield corporate credit market where there is higher average rating and lower leverage with a lot of that excess lending over the last decade having migrated into the senior secured loan space and into the private credit markets. Much will depend on the trajectory of interest rates over the rest of the year, and on balance it seems at the moment that the market is still too wedded to the idea of cuts coming sooner than later, which does not seem consistent with Fed narrative or the stickiness of core inflation. While it does seem the Fed is close to the end of its hiking cycle, with inflation still well above its target it seems it may well end the cycle with a long pause at the top rather than a quick pivot to a cut. Furthermore, the ECB and Bank Of England look to be set on further hikes, while the Bank of Japan really has only one way to go. As such, while much of the central bank tightening may have been priced in, it feels too early to add duration, and really we need to wait until the point at which it seems recession is in full swing to do so, and a nimble approach here could really pay off. So for now we prefer a neutral duration positioning, but remain alert as we know that duration can again act as a risk-off hedge. With a higher starting point than in recent years, yields now have room to fall in a flight-to-quality situation. We saw this when the US regional banking stresses emerged in March, and then again when First Republic failed in early May, before things calmed down once more – so the length of the central bank 'pause' will be crucial in judging when to start adding duration back for the longer term, and we anticipate this to be towards the end of 2023.

Major 10yr Bond Yields - Japan the outlier



The Bank of Japan is still suppressing its yield curve and maintaining a loose monetary policy, so its bonds are yielding a lot less than elsewehre. A reversal of this could send shockwaves through financial markets.

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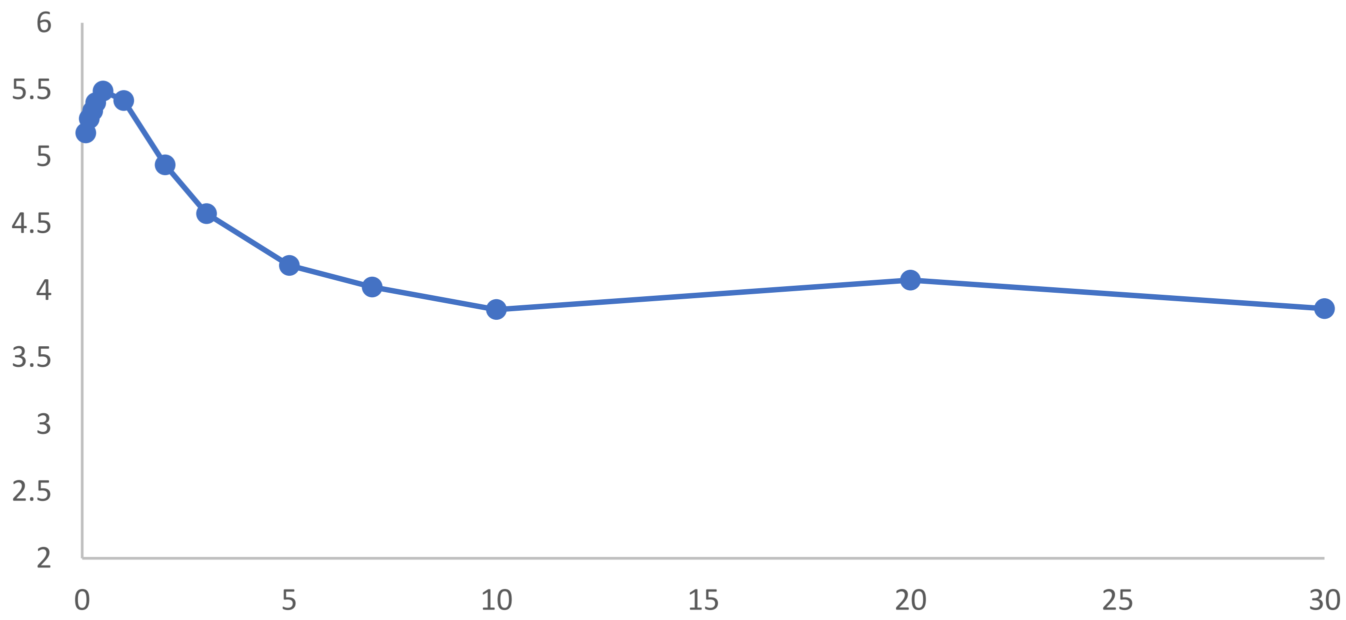
FIXED INCOME								**The cloudy inflation outlook precludes us from being over-optimistic towards bonds, but with yields more normalised and economic slowdown looming, an upgrade to a neutral weighting is justified.**
Sovereign Bonds								We prefer Treasuries to Bunds and Gilts as the Fed appears nearer to cuts than the BOE or ECB. Economic slowdown should provide demand.
Corporate I.Grade Bonds								Short duration high quality IG yielding 5/6% is appealing as the core of a bond portfolio. Duration's time will come, but not yet.
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.

Our key ethos for the bond markets continues to be a diversified, global outlook with holdings across different regions and pockets of the fixed income universe – and this is especially important when major (US) yield curves are inverted, as some markets actually have very steep, positive yield curves where investors will be rewarded well. Many emerging market central banks in particular are starting to cut rates in the face of decelerating inflation (as the prices of goods which make up a bigger percentage of the EM region's inflation basket, are falling quicker than services), and offer decent spread and carry, supported by a weaker Dollar. Also our longstanding position in European asset backed bonds remains a favourite of ours and is doing well year to date – the European mortgage market has a far lower default rate than in the US, and low correlations with the rest of the bond market. While we must be wary of rising consumer stress and debt defaults due to higher rates, the long term, steady income streams of ABS tend to drive longer-term total returns more than spread movements over time and are currently attractive in terms of historic valuations.

US Treasury Yield Curve

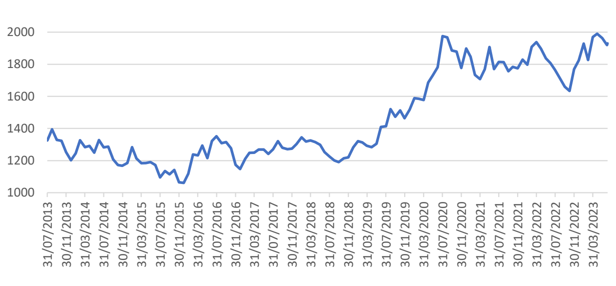


The yield curve is deeply inverted which has historically preceeded a recession - we don't believe equities are priced accordingly.

CURRENCIES AND COMMODITIES

Currencies year to date have more or less followed the 'carry' direction of their corresponding central banks and the level of inflation present: Britain has the highest inflation among the major economies and thus needs more rate rises so GBP is the best performing currency; the Fed is nearing the end of its cycle having commenced hiking earlier so the Dollar has been weak; the ECB doesn't have inflation quite as sticky as the UK but has further to go than the US so the Euro has underperformed GBP but strengthened versus USD; while the BOJ has been maintaining loose policy and the Yen has taken a battering as a result. Our view is this pattern is likely to persist until inflation levels have moved nearer the longer-term averages for the respective regions. After years of dominance following a combination of rising relative yields and its appeal as a safe haven destination amid falling equity markets, it maybe that the US Dollar bull market is transitioning to a bear market.
This will not happen in a linear fashion, of course, and may take a while to pan out. For example, in the near term the Dollar may regain a little if rates do indeed stay higher for longer than the market expects or indeed if the Eurozone slips into a deeper recession than is apparent. Perhaps the two most interesting currencies at the moment are the Swiss Franc and the Japanese Yen: in the short term the Franc looks more likely to benefit from the rapidly declining inflation in Switzerland and rates there, while longer term the Bank of Japan has the greatest propensity to shock currency markets with a change in policy from a base so far behind other developed economies. Cyclically sensitive currencies such as the Australian dollar, Norwegian krone, and Canadian dollar, which also have lower interest rates than the US dollar, are likely to remain soft until the extent of the global slowdown is clearer.
Gold has fallen back from its highs as investors start to relax about some of the major geopolitical risks of recent times: Covid, the Ukraine war and a banking crisis, and technically it looks weak having dipped below its 100 day moving average as ETF purchases have fallen away. However, while some of the more visceral risks may have faded, that Gold has dipped as other financial markets start to price in looser policy suggests its price should be supported (as a non-income bearing asset) and it also acts as a hedge against a weakening US Dollar. Alongside Gold, silver remains an attractive (if frustrating) companion in our portfolios – while investment demand seems mixed, physical demand for the metal in electronic applications and electricity conduction is extremely strong and could continue to see a secular rise as the energy transition – the move towards renewable forms of power production – gains further traction. Most recently Chinese demand for silver for the purposes of solar panel production has hit record levels.

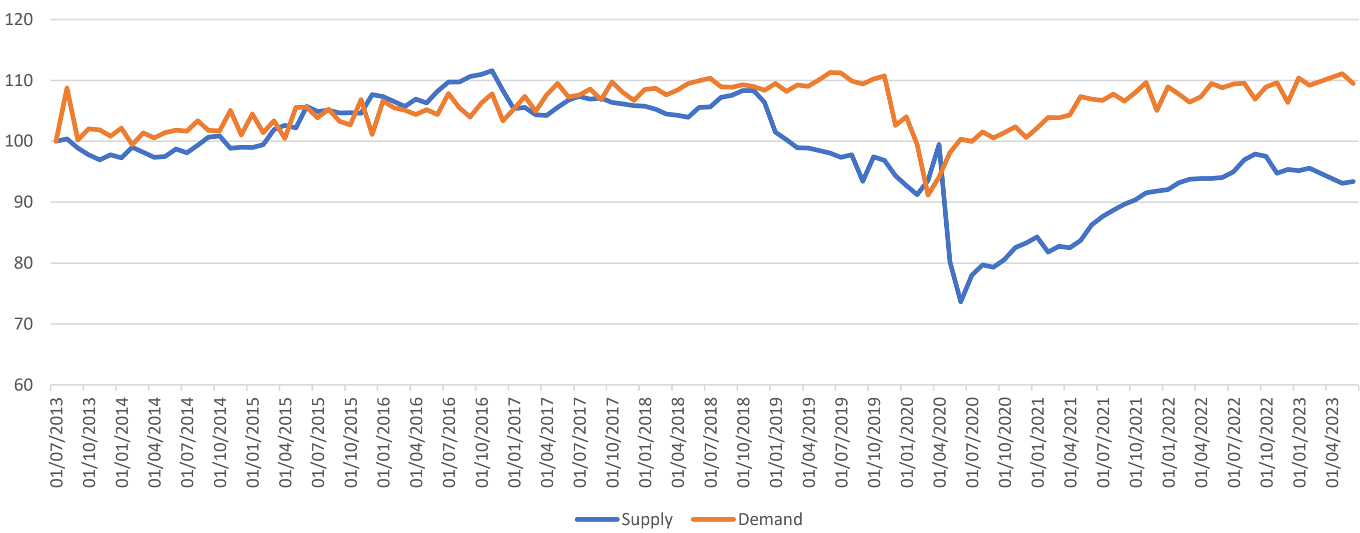
Gold Spot price $



Gold is off its highs, but is well supported by central-bank buying and the long term prospect of lower rates.

The cyclical nature of oil may work against it in the coming months should a slowdown become more apparent and consumers react to higher prices, yet this dynamic does not always play out in reality – typically a decoupling occurs when there is a geopolitical shock or disruption/sudden excess of supply. While the long term threats to the oil market are well known, in the medium term OPEC+ has a relatively tight control over the supply of Crude and is actively reacting to bouts of falling demand, seemingly keeping the price at around $70. In the energy space generally, the low carbon transition has dis-incentivised investment in the supply of fossil fuels resulting in supply being reduced at a faster rate than demand has been curtailed and so we have seen higher prices than one might expect given the long-term bearish narrative. While some short term economic considerations may hold fossil fuels and industrial metals back, we know the low carbon-transition cannot happen without them – so some exposure in a portfolio makes sense.

Oil: Demand is beating Supply = higher prices



While demand for crude remains steady, OPEC+ cuts of a million barrels a month are starting to reduce supply.

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Citywire 2019: 'Top 30 Influential Fund Selectors'
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