BANQUE HAVILLAND

Q4 2023 OUTLOOK

OCTOBER 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, Dubai and Switzerland.*

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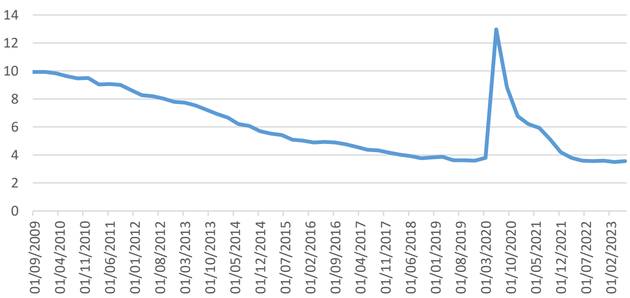
MARKET ENVIRONMENT

Markets and investor sentiment remains torn between optimism over peaking inflation with expectations of a ‘soft landing’ for the economy, and fears of a ‘higher for longer’ rate environment. As such we note that since the end of the new-year relief rally in January, most equity markets are flat or mildly in the red and furthermore government bond yields are now higher than they were a year ago. September is statistically often the worst month for stock markets, and it will be interesting to see whether this years’ softness was pure seasonality or the beginnings of a more meaningful trend – interestingly the fourth quarter of the year is often the best, further confusing the outlook! Commodity markets (with the exception of crude oil) are also in negative territory for the year.

US Unemployment %



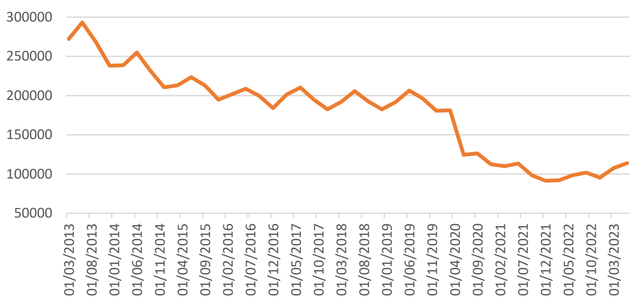
While unemployment remains low, the Federal Reserve will not have to worry too much about cutting rates.

This all adds up to another difficult year for multi-asset investors and active money managers alike, especially if they are not substantially exposed to the stocks benefiting from the AI boom. Those waiting for a Fed pivot towards lower rates have been frustrated by the resilience of the US economy, and even if most of the heavy lifting by central banks in their battle against inflation has now been completed there is a growing realisation that we will not be returning to an era of cheap money that has buoyed risk assets for so long in recent years. Adding to this uncertainty is the worry that the full effects of tighter monetary policy and the resulting higher cost of credit has yet to truly feed through into the real economy, at a time when household’s post-pandemic savings are starting to diminish. Nevertheless, the slowdown expected by the majority of commentators for 2023 has not yet transpired, and while stocks have flat lined there has not been a major correction. The US Banking crisis and the collapse of Credit Suisse seem to have been long forgotten, and while we do not wish to be overly cautious, assumptions that there will not be a recession at all now makes little sense to us. Some aspects of economic data have improved a little since the challenges of the first quarter, but it is likely that these can be attributed to temporary factors rather than to healthy economic growth.

“Those waiting for a Fed pivot towards lower rates have been frustrated by the resilience of the US economy, and even if most of the heavy lifting by central banks in their battle against inflation has now been completed there is a growing realisation that we will not be returning to an era of cheap money that has buoyed risk assets for so long in recent years.”

In particular, falling gas and energy prices from the start of the year have allowed stronger growth than anticipated (especially in Europe) and the reopening of the Chinese economy (while not the explosive catalyst for global growth many expected) will at least have contributed to cushioning a slowdown. It is surprising that there haven't been further signs of cracks appearing in the global economy in recent months, but then this could be explained away by some of the peculiarities of the post-pandemic rate cycle - i.e. the rapid ascension of rate rises (from near-zero to over 5%) has yet to bite into the economy due to the excess savings accumulated over the Covid period that are still being drawn upon.

US New Bankruptcy Cases Total Filings

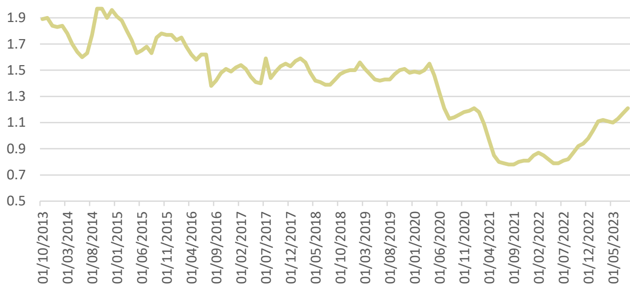


Companies are starting to go bankrupt at an increasing rate, although from a very low base in 2021. The effect of higher rates has likely yet to be properly felt.

Similarly, corporate earnings are still elevated with households and corporations having taken advantage of low-rate, long term debt deals and many companies choosing to hoard labour rather than risk rehiring at more expensive future levels. However, these factors would point to a delayed downturn, rather than none at all so perhaps a recession will simply come later in 2024 once the higher interest rates and rising wages start to bite into corporate profitability. Many companies, for example, are earning interest on their deposits but are not yet paying extra for the debt they accumulated at ultra-low rates during the pandemic. This situation could reverse rapidly as corporates begin to refinance their debt next year.

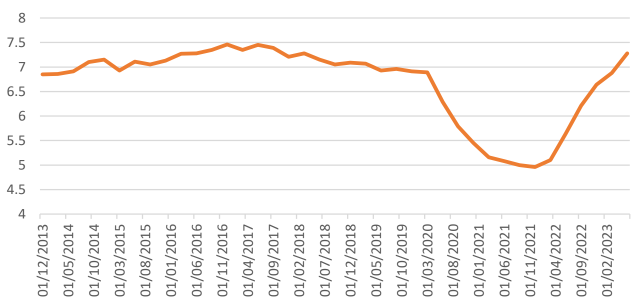
Many investors think that with an unemployment rate of 3.5%, the US economy is somehow invulnerable to a recession, but this could be misleading as recessions almost always start when the jobless rate is at or near a low. It remains our assumption that the aggressive global monetary tightening that started in early 2022 will cause some stress for the economy, however, we are open to the likelihood that in the meantime equities can make money for investors due to the shifting regional and style trends that can be captured by an active approach, while the current nature of the bond markets means that decent short term income can be made with little need to take significant duration or credit risk. Essentially, we believe that a strategy that combines a heavily selective, regional approach to equities with a short duration/ short maturity focused fixed income allocation (together with a portion of uncorrelated assets) enables a fully invested portfolio in spite of the uncertainty of the macro outlook.

US Credit Card Delinquencies



After 20 years of falling delinquencies, US credit card holders have started to increasingly miss payments over the past year. This could be an early warning sign that the consumer is starting to struggle.

US Auto Loans Delinquency Rates (10 years)



Along with credit cards, US consumers have been missing car loan repayments too - though time will tell if this will surpass pre-pandemic levels. (Many people paid down debts during the furlough period).

EQUITIES

When there is such a clearly dominant theme driving sentiment and direction in the equity markets (i.e. the inflation/rates outlook), we are minded to pay heed to the familiar adage of 'don't fight the Fed' above all else, and this means paying attention to what the central bank policy makers are saying. As such we must be mindful that Jerome Powell at Jackson Hole stated inflation 'remains too high' and that the US central bank would 'be prepared to raise further if appropriate', which all else being equal suggests that higher rates are here to stay – and means that businesses will need to adapt to a longer period of higher financing costs than they have been used to in the last fifteen years or so. In order for this scenario to not transpire we would probably need to see either/or a sizeable tick up in unemployment and a faster than expected drop in inflation – as it stands this is patently not the case. Certainly much of the heavy-lifting in terms of quashing inflation (from the central banks point of view) has been done but there would be little logic in abandoning a hawkish tilt too early – inflation has shown that historically it can reinvigorate itself with some vigour when central banks declare victory by cutting rates too soon. Nevertheless, policy makers will be mindful of some early warning signs flashing in the real economy, (not least US Bankruptcy filings and credit card delinquencies that are starting to creep upwards) and will not want to be seen to drive the economy into recession with excessive hikes – thus the path of least resistance would appear to be holding rates and waiting. We would posit that equity markets themselves are waiting, as demonstrated by the sideways trading we have seen since February, and we were not surprised by the autumn selling that has occurred as investors returning from the summer holidays reconsidered the chequered economic outlook.

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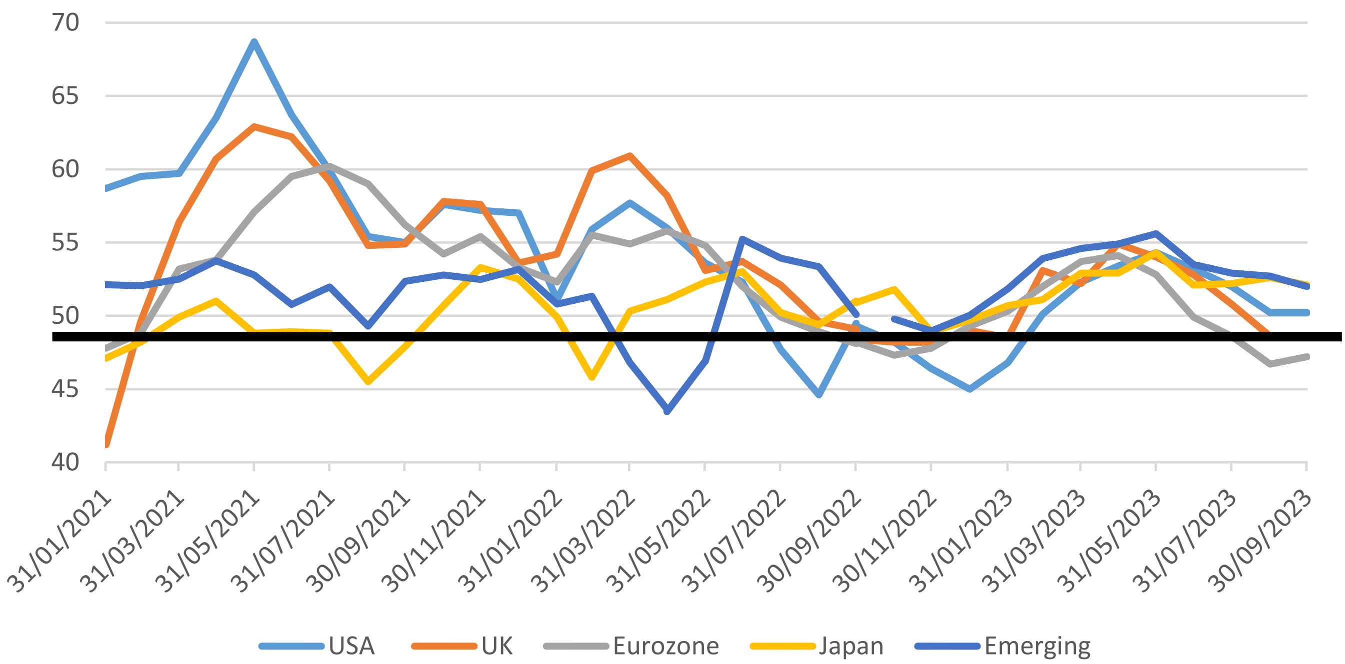
EQUITIES								**Sentiment continues to be pulled by fears of higher rates for longer and pushed by expectations of a soft economic landing. We expect earnings to fall, but there are opportunities for active investors.**
US								Most companies are treading water outside of the AI boom, as the US economy remains resilient but moderate.
UK								British stocks are still very cheap and GBP appreciation attractive for EUR, USD investors. Growth revised up, but tepid. Wage inflation a problem.
Eurozone								ECB are data dependent and recent PMI's indicated weakness, which will drag on cyclicals. There are strong, resilient businesses to buy.
Switzerland								Quality, defensive nature of the market continues to see Swiss stocks in demand, though valuations relatively rich now. We like CHF.
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 humming. Appreciating JPY should offset QT for foreign investors.

Of course, the market 'highs' we saw in August were far from a rising tide that lifted all ships, with the reality being that a handful of mega-cap companies on both sides of the Atlantic were responsible for the gains seen at index level. Without wishing to again dwell too long on the well-established lack of breadth in 2023's equity market, much of this year's gains have come from multiple expansion driven by growing enthusiasm in Artificial Intelligence in the US, while in Europe a small concentration of large pharmaceutical companies have given the impression of better performance than the region deserves. For stock investors not exposed heavily to these mega-caps, it is unlikely they have seen any gains at all. We suspect however, that the enthusiasm around AI may become overshadowed by the travails of the real economy amid higher rates, and by weaker earnings growth than we have been used to in recent years. Earnings remain essential for longer-term performance, so our philosophy also remains wedded to pursuing stocks that post positive realised profits. Despite concerns about inflation and interest rates, corporate profitability has held up well, and many companies are exceeding expectations with earnings having fared better than anticipated, though we fear the aforementioned higher cost of financing may start to erode these eventually. Looking for companies that have low debt levels will be especially pertinent. Much of the recent equity market softness can be attributed to the rise in bond yields (precipitated by fears of higher for longer rates), and unfortunately for equities this means that they will appear increasingly less attractive than bonds on a relative valuation and income metric, though a return to 2022's increased correlation between stocks and bonds is no comfort for bond or multi-asset investors either. Though the market's preoccupation with inflation and rates is undeniable, as long term investors rather than traders we believe that a disciplined emphasis on valuation, earnings growth potential and income generation will be key to navigating a new environment of higher costs of capital and lower returns in general for equities. Specifically we continue to tilt our equity portfolios towards value stocks, noting that although the US value index has outperformed it Growth counterpart over the past year, the outperformance has started to converge with the valuation spread now where it was this time last year.

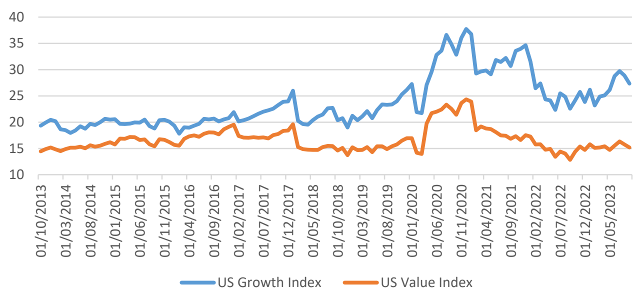
Composite PMI Readings



The major global regions' economies are once again moving in lockstep, following the divergences of the Covid era. Europe is indicating contraction, while only Japan and Emerging markets appear to be looking forward to growth (i.e. above 50).

This seems counterintuitive to us at a time that most are expecting higher rates to have an increasing impact on future economic activity, when logically companies with more distant cash flow profiles (i.e. 'growth)' have more to lose. Furthermore, it is likely that stocks that have robust, or indeed, growing dividends will be in demand - so a combination of this characteristic with a reasonable valuation makes for a compelling stock investment in the current climate. Regionally, there has been some significant divergence this year and we feel that this will continue, thus creating opportunities for active investors. Consistent with our above preferences we like Swiss stocks for the general quality of the companies and the strength of the Franc as we approach uncertain times, while Japan (long a favoured market of ours before it recently became a consensus view) remains our high conviction country for equities. To date, we have not enjoyed all the gains that the Topix has provided due to the weakness of the Yen, and indeed this could extend for longer while the FX markets digests the expectation of higher rates in the US, but we feel that the potential for a turnaround in Japanese policy offers asymmetric upside for JPY. Besides, the Japanese economy is purring and valuations are still preferable to other developed economies despite the year to date rally. We are not so keen on European stocks in light of the flagging forward economic indicators, and German equities in particular have epitomised the regions' slowdown thanks to higher borrowing costs, still elevated inflation and a rebound in oil as the DAX has retraced heavily in recent weeks. The cyclical nature of the DAX (industrials make up over 20% of the index, with heavy representation of consumer discretionary stocks such as car manufacturers) does not bode well in case of a general slowdown, and we feel that investors may favour value and defensive shares at Germany's expense. As such the UK market looks more appealing, particularly with its low valuation and commodity companies that will benefit from the higher energy prices, as well as banks that will prosper in a period of higher base rates. Survey data is still weak in Britain, however, hard economic data has been better than feared and concerns of a deep, imminent recession have faded and the high dividends on offer could draw foreign interest should the Pound find a bottom. Contrary to certain misconceptions, the UK all share index has outperformed the US 500 and World Index over the past three years. European stocks are likely to lag behind US peers overall as higher-for-longer becomes a reality, especially if the economy suffers as a result, not to mention the German exposure to China which is damaging sentiment. As such we are wary of too much exposure to Europe, though there are of course a number of resilient, recession-proof companies that are worth consideration in any part of the cycle – French and Italian luxuries spring to mind.

Growth v Value Valuations (P/E)



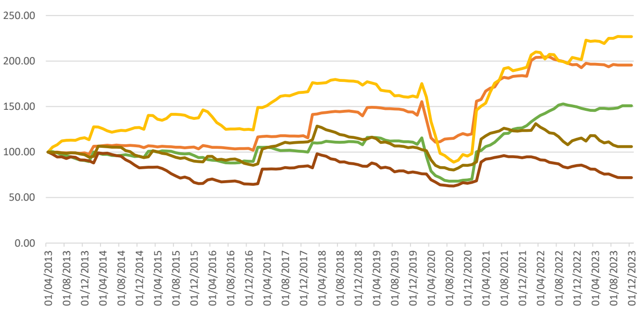
Despite some convergence between the valuation of Growth and Value stocks in 2022, the gap has once again widened, making Growth stocks look very expensive historically.

Our allocation to Asia, and specifically China, have been a source of frustration as sentiment towards China has soured throughout the course of the year – hopes remain that stimulus could return in earnest to give the struggling economy a boost, but so far this has not been forthcoming.

There are real fears that the travails of the real estate sector will spill over into the rest of the economy at a time the country is losing trade as a result of 'friend-shoring' by Western countries, which is making the Chinese transition to a consumption-based domestic economy more frenetic than the ruling communist party would like.

It may be that other emerging markets that are benefitting from friendlier terms with the US and Europe are set to benefit from China's loss – we note that the EU is currently trying to revive a trade deal with Latin America's largest trade block, Mercosur. Mexico is already enjoying enhanced trading with the US as businesses switch their operation there from China and it is likely that other central and southern American economies will see leading international manufacturers opening factories as well. When one considers all the natural resources abundant in South America that will be essential for the global renewable energy transition, as well as the biodiversity that is ideal for food production, it is clear that the region is well worth a closer look for long term equity investors.

Earnings Estimates



With the exception of Japan, earnings across all regions have been tailing off. Europe and the US estimates are still above their long term averages though, which when combined with higher forward financing costs, could mean further re-rating.

> *"(...) the Japanese economy is purring and valuations are still preferable to other developed economies despite the year to date rally. We are not so keen on European stocks in light of the flagging forward economic indicators, and German equities in particular have epitomised the regions' slowdown thanks to higher borrowing costs, still elevated inflation and a rebound in oil as the DAX has retraced heavily in recent weeks. The cyclical nature of the DAX (industrials make up over 20% of the index, with heavy representation of consumer discretionary stocks such as car manufacturers) does not bode well in case of a general slowdown, and we feel that investors may favour value and defensive shares at Germany's expense."*

FIXED INCOME

The recent sell-off in US Treasuries to yields of over 5% in both shorter-dated and 30-year bonds looks like the most attractive entry point to the asset class for over 15 years, though this may be of little comfort to existing holders of bonds who since the end of 2020 have witnessed losses of 23% (Global Aggregate Index). The inverse relationship between higher inflation and rates is well known but the rise in yields has undoubtedly been brutal, as years of artificially excessive easy monetary policy, post-lockdown supply/demand disruptions and the outbreak of war in Ukraine conspired to unleash higher prices on the world and a subsequent ultra-aggressive ratcheting of base rates by central banks. We have fortunately shielded our multi-asset class portfolios from the brunt of the losses by persisting with a short-duration, low maturity approach having resisted the temptation to chase higher yields (and as such negative real returns), along with a highly diversified global bond and credit approach. For now, we believe this is still the correct allocation mix. Logically, if one can receive 5.5% yield by holding 6 month T-bills, with the short-term flexibility this brings in an uncertain forward rate environment, then being paid 5% for 10 or 30 year debt makes little sense. Essentially the market got ahead of itself in being convinced that inflation was in a smooth and rapid descent and that this would allow central banks to cut rates at the first sight of a deteriorating economy – but to the detriment of the bond market, economic data has held up better than expected and central bankers have been keen to stress their commitment to extinguish inflation. As our base expectation is for core inflation to slowly fall (though unlikely in smooth fashion) and stay above the Fed and ECB's target of 2% well into next year, at a time that energy prices are holding at we think there is no reason to look at increasing duration just yet, but suggest remaining liquid and flexible upon signs of meaningful economic weakening. The attractive yields on offer at the front end of the curve allow us to hold a neutral weighting in bonds which we couldn't prior to this year when real yields were so paltry, and most of this allocation consists of high quality Investment Grade debt with short-dated US Treasuries, UK Gilts and A-AA rated corporates. Elsewhere we remain cautious, even in US treasuries where the larger (and growing) deficit means a higher supply of government debt which will place further pressure on yields – Treasury supply is expected to rise by 30% next year.

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FIXED INCOME								**Headline yields are now above fair value, and while there may be further inflation shocks, short maturity bonds can once again be useful to offset equity risk.**
Sovereign Bonds								We prefer Treasuries to Bunds as the Fed appears nearer to cuts than the BOE or ECB. Economic slowdown should provide demand. Avoid Japanese.
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.

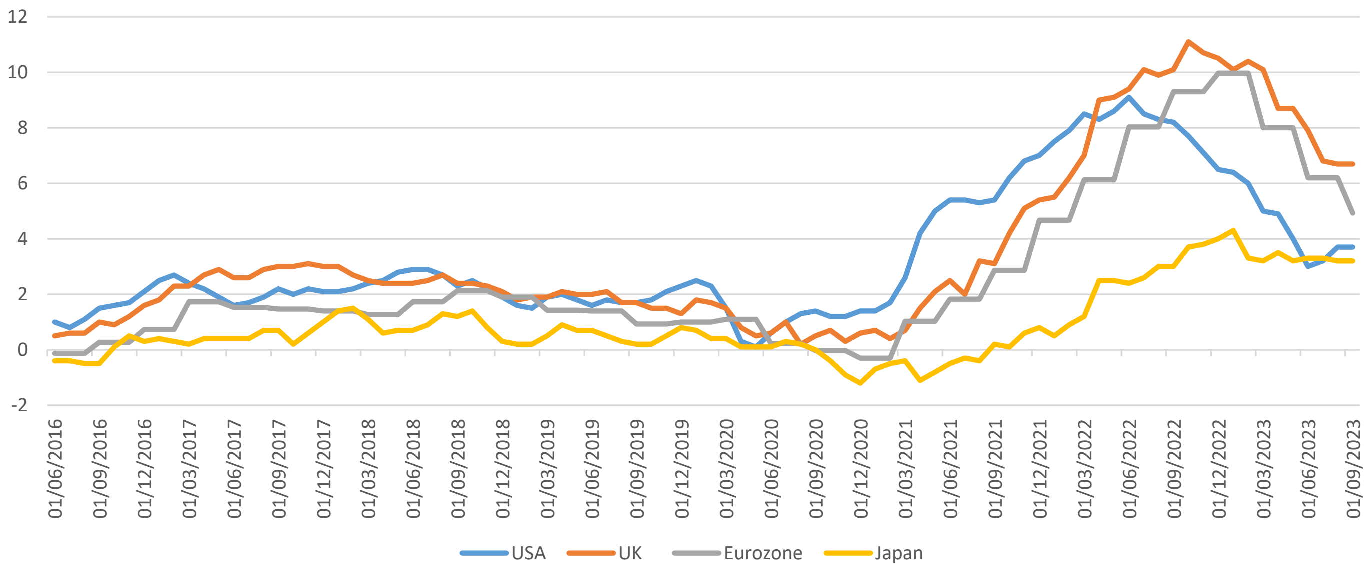
We are neutral on core European debt, as the ECB seems more likely to pause its hiking cycle, and while growth in the Eurozone is anaemic there are pockets of corporate issuance that can withstand the slowdown while offering good yield and credit ratings, e.g. retail banks. Corporate fundamentals still look relatively healthy in Europe, with a worthwhile spread over sovereign bonds in the Investment grade space. Early signs of stress within the small-cap US space and loans market as identified above makes us reticent to hold too much high-yield debt and the risk premium of around 4% over treasuries is not really sufficient. Though we note that year to date junk bonds have done pretty well – defaults are sure to increase so we retain a small allocation to the safer end of the high-yield market. We prefer a higher weighting to Emerging market bonds than to high-yield in general, though with real rates now at multi-decade highs, there are questions over whether debt sustainability might become a problem for some nations.

2 Year Bond Yields

COUNTRY	MATURITY	YIELD + / -
ICELAND	12/06/2025	9.51
NEW ZEALAND	15/04/2025	5.72
UNITED STATES	30/09/2025	5.03
BRITAIN	22/10/2025	4.89
CANADA	01/11/2025	4.81
ISRAEL	30/04/2025	4.45
NORWAY	19/02/2026	4.16
HONG KONG	25/08/2025	4.11
AUSTRALIA	21/11/2025	4.05
ITALY	29/09/2025	3.97
SINGAPORE	01/11/2025	3.68
SPAIN	31/05/2025	3.53
SWEDEN	12/05/2025	3.45

COUNTRY	MATURITY	YIELD + / -
FRANCE	25/02/2025	3.41
GREECE	15/02/2025	3.34
AUSTRIA	20/04/2025	3.33
BELGIUM	22/06/2025	3.31
FINLAND	04/07/2025	3.28
IRELAND	13/03/2025	3.20
NETHERLANDS	15/07/2025	3.20
GERMANY	18/09/2025	3.14
PORTUGAL	15/10/2025	3.13
DENMARK	15/11/2025	3.08
SWITZERLAND	24/07/2025	1.18
JAPAN	01/10/2025	0.05

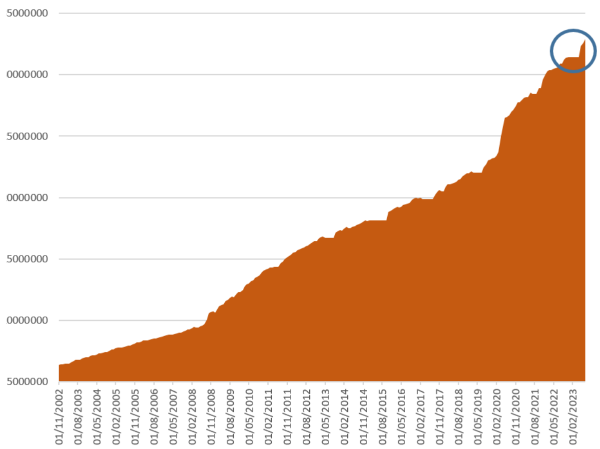
Inflation (year on year) %



Inflation has clearly peaked, but remains well above the most central banks' target of 2%. The recent uptick in US CPI shows it is unlikely to be a smooth fall, and points to 'stickiness' which is causing market jitters.

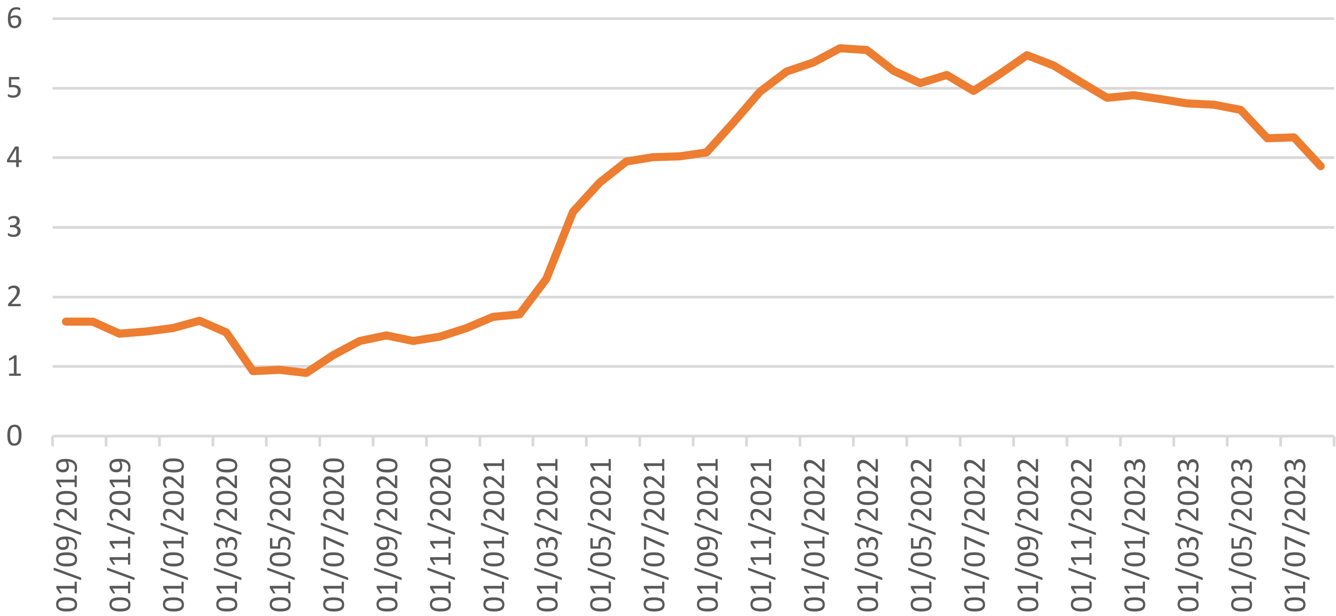
While there are some debt trouble spots within the developing world, generally many have raised rates harder and faster than many developed countries and so are better positioned to adjust to an economic slowdown. Lower Chinese growth can be offset by more optimistic forecasts in Latin America and other Asian nations (such as India), but it remains prudent to discount countries prone to political unrest. Finally, in contrast to our preference to the countries Equity market, we especially avoid Japanese government bonds as the loose fiscal and monetary backdrop there will have to reverse soon and this points to a severe re-rating of JGB's with yields currently very low.

US Total Outstanding Debt ($ Millions)



Under the Biden regime, US borrowing and debt have taken yet another leg upwards. The bond markets are watching this...

US Personal Consumption Expenditure Index



The PCE Index is closely watched by the Fed for guidance on how the US consumer is behaving. The steady drop in 2023 suggest the rate hike are taking effect.

CURRENCIES AND COMMODITIES

Dollar strength returned with a vengeance during the summer as the classic drivers of a stronger greenback (a higher US interest rate outlook and, latterly, general market jitters) combined to reverse the declining trend that started at the end of 2022. The relative resilience of the US economy also supported the appeal of the Dollar. It is quite possible this strengthening will continue throughout the rest of the year until the market has a more settled view of the Federal Reserves ability to pivot towards a rate cut – and as such the typical 'risk' currencies like the Euro and Sterling will come under pressure, while we expect the Swiss Franc to hold its value through the volatile period. However, we stick with our view that the Dollar will weaken as we get close to 2024 as other major central banks catch up with the Fed, and the US economy perhaps loses some of its lustre.

On balance, we prefer the Pound to the Euro as GBP looks a little oversold now, particularly as economic data has consistently beaten (low) expectations and inflation finally seems to be falling on a faster trajectory (from a higher base) than in the Eurozone. The ECB seem more cautious than the BOE in reeling in inflation at the cost of a recession it seems. The prospects of a higher Japanese Yen are likely to coincide with the point at which the Dollar runs out of steam, and while this means short term downward pressure, the rebound potential of JPY in the medium to longer term is significant – therefore we are watching the Bank of Japan carefully for further hints that they will loosen their grip over the bond yield curve, thus freeing the currency. China's post-pandemic recovery has underwhelmed and following years of lockdowns, Chinese consumers are now reluctant to spend.

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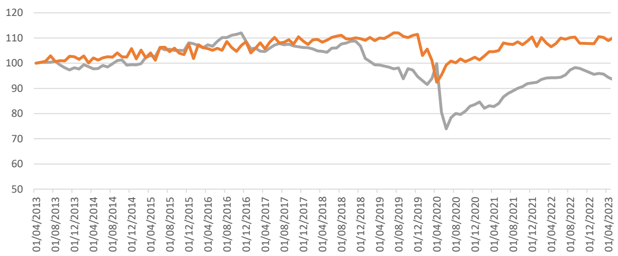
CURRENCIES				**Despite recent USD strength, the FED is near the end of its rate cycle. Much will depend on inflation in Europe, and how quickly it catches up with the US.**
U.S. Dollar (DXY)				The dollar had a good summer due to the resilience of the US economy, and perhaps, premature expectations of rate loosening. Both factors look set to unwind.
Sterling (GBP)				Recent weaker inflation print has muddied the BOE outlook, but GBP unlikely to see immediate further weakening.
Euro (EUR)				ECB direction is inflation and data dependent, so immediate direction is unclear. Slowing growth as indicated by PMI's may drag.
Japanese Yen (JPY)				In the long term, JPY has potential to significantly breakout when and if BOJ loosen curve control. For now loose monetary policy remains.
Swiss Franc (CHF)				CHF looks well set, with the prospect of incremental higher rates amid steady inflation.
EM				China stimulus and the first rate cut in some years may hold CNY back. Other EMFX's may do well as the Dollar weakens.

Policymakers recognise that reviving the real estate sector, in which much of consumers' wealth is locked, is one way they can help restore confidence, another is maintaining the credibility of the currency which has been under pressure. It is probable the determination to peg the Yuan at higher levels will grow, so the worst of the fall for CNY has already occurred – while so far the Peoples Bank of China and other Asian central banks have relied on words to defend their currencies, they have ample Dollar reserves which they can call upon.

The prospects for commodities is nuanced both in terms of time frame and category. As ever the wider markets and economy are mainly focused on Crude Oil due to its still essential role and influence upon global inflation. Consensus is for a barrel of crude to oscillate around the $90 mark, which is a level that Saudi Arabia/OPEC would seemingly be content with, and that the global economy could just about cope with at a time inflation is being battled. The resilient US economy and the likelihood that Chinese economic activity has troughed, may well lay a base under the crude price, and the market remains tight enough that OPEC can quickly influence any short term fluctuations.

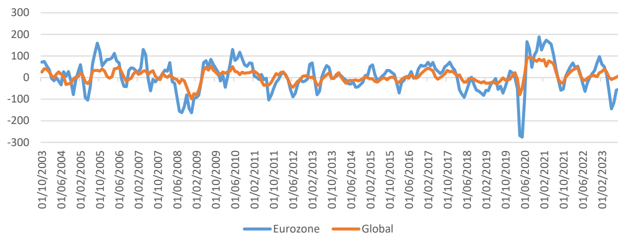
Oil: Demand is beating Supply = higher prices



Following a period of convergence after the 2020 demand shock, supply has started to drop off as OPEC controls production while demand remains steady. This suggests support for oil prices at current levels.

For copper, the long term fundamentals look strong due to energy transition (EV, renewables, etc.), and in the near-term, most analysts expect traditional drivers (such as manufacturing and construction) to spur a rebound in demand. Political uncertainty in Argentina and Chile, two key regions for copper, have contributed to the lack of project approvals, while there are no particular concerns about oversupply, in part due to the smaller uplift in new project approvals relative to previous cycles and a slowing in growth from big projects. There are likely to be near/medium term knocks to sentiment with respect to the materials required for the transition to renewables, as governments are forced to row-back on some of the more unrealistic targets (e.g. bans on ICE vehicles by XYZ date etc), but the long term opportunity remains compelling. Whether investors choose to gain access to the transition via the essential base materials (lithium, copper etc), or the companies and funds that are exposed to these trends – we think most portfolios require at least some weighting to the theme.

Citi Economic Surpise Index - Global v Europe



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. Europes' outlook is bleak.

Likewise, we advocate a structural allocation to Gold as a sort of insurance policy against market turmoil – it has historically acted as a safe haven, with investors flocking to it in difficult times. Often the precious metal will initially fall alongside other risk assets in a sell-off, but then rally as equities and other commodities remain under pressure. Gold has actually held up well recently considering the improving picture for real yields, and this has probably been due to central banks buying to diversify their reserves and retail investors buying as concerns of a recession increase. It is difficult to put a 'fair value' on the price of gold, but at $1800 with the current uncertainty facing investors, it seems as good a diversifying option as any.

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