BANQUE
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MONTHLY NEWSLETTER
MARCH 2023

SOMMAIRE

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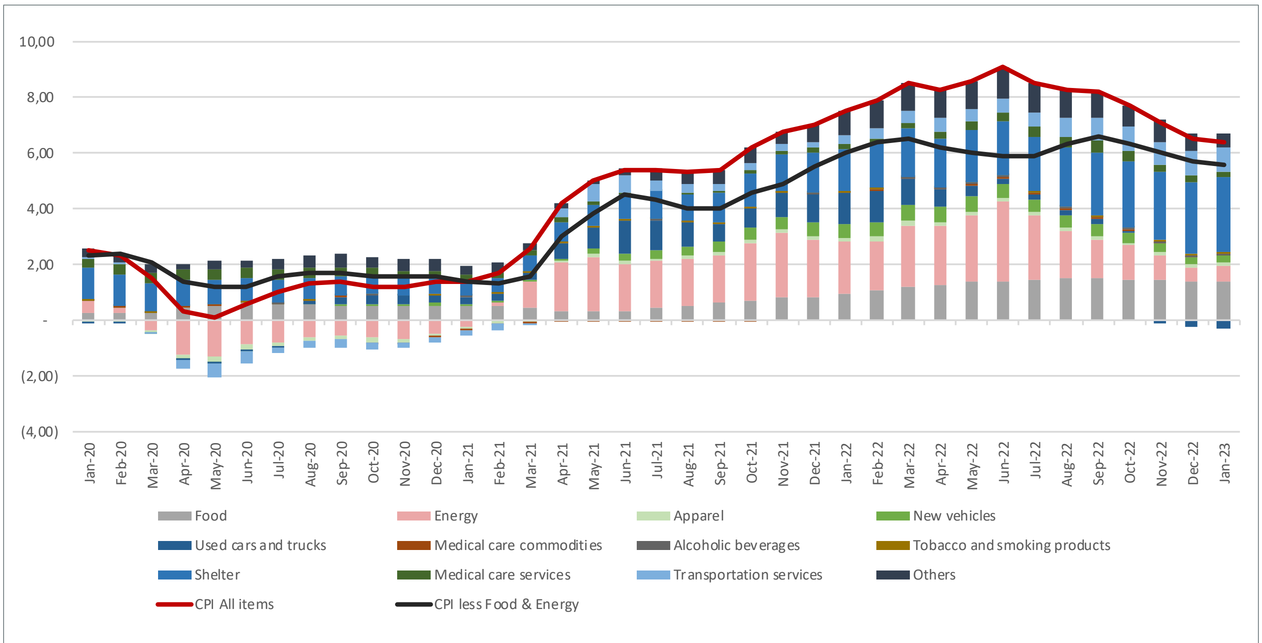
1. EDITORIAL

NOT SO QUICK...

After last month's strong rebound, the performance of financial markets stalled in February in a consolidation move that spared very few asset classes. This situation echoes the cautious message we delivered last month in the wake of a strong and sudden rebound. Sadly enough, February 23 also marks the anniversary of the Russian invasion of Ukraine: a "special operation" that was supposed to last only a few days or weeks and which is now a year old war and projected to last for the foreseeable future.

Once again, the topic of inflation is at the roots of financial markets' sudden reversal. After several months of marked disinflation, the subject was less at the forefront of investor's thoughts and had already been adressed in the minds of the most optimistic. The release of a consumer price index at 6.5% YoY in January, virtually unchanged from last month, proved that the decline will be slow. To put the disinflation of the past few months into context, it must be said that most of it came from lower energy and food (to a lesser extent) contributions (see graph 1), where marginal gains are becoming harder to achieve. On the other hand, despite the numerous rate hikes done by the Federal Reserve, price pressures in Services are failing to abate. With more than 500,000 new jobs created last month and an unemployment rate falling to a historic low of 3.4%, wage pressures remain strong and are contributing to those price pressures. Finally, despite the drastic increase in mortgage rates and the subsequent decline in existing home sales (down 36% over one year), real estate prices are holding up and the increased pressures on rents resulting from the decline in housing affordability continue to translate into a larger shelter component in the CPI basket.

G1 : US CPI AND ITS MAIN COMPONENTS



Source: BLS, Banque Eric Sturdza, Jan 20 to Jan 23

While the economy remained pretty "hot", market participants started to pay more attention to the FED's speech and reached the conclusion that the FED fund terminal rate might be higher than previously expected and that higher short term rates are probably in place for longer. Under such conditions, the US 10-year yield rose by 40 basis points over the month (penalizing investors that went long duration too early), the US dollar that had been under pressure strengthened again with a more hawkish FED and U.S. markets slightly consolidated. Worth noting that on the downturn, US markets continued to underperform major world indices such as the STOXX600, the SPI, the FTSE100 and the TOPIX. To help explain this trend, we must consider several factors: 1- The collapse of natural gas prices and resulting positive side effects for Europe, 2- a more significant valuation cushion for stocks in the Euro-zone, United Kingdom and Japan, and 3- a relatively light positioning by global investors in these regions.

Once again, the exception remains Chinese assets. After three months of violent repricing and skyrocketing prices that followed the decision of Chinese authorities to considerably loosen zero-covid policies, the Chinese market is pulling back in February – more significantly in local currency for the offshore markets (Hong Kong, ADRs) than the domestic ones (A shares). The Yuan also depreciated somewhat and returned to the level reached against the USD at the the beginning of the year. While the February correction of Chinese equities was painful (-9% for the MSCI China), it has to be put into perspective with the sharp rebound experienced between November 22 and January 23 (+52%) and is reminds us hat the reopening process and the economic recovery of China are not linear processes and can be a source of volatility, most notably as tensions between the US and China remain high. The shooting down of a Chinese air balloon is a good reminder of that.

Although the investment environment appears healthier and more promising after the 2022 reset, February reminds us that caution is a given, most notably in a macroeconomic context depressed by persistent inflation and with the ongoing war in Ukraine. The year 2023 could remain volatile and correction episodes should be used as selective opportunities to reposition portfolios, especially for investors that missed Q422 rally.

2. FIXED INCOME

TEMPORARY DISINFLATION?

The FED: Already ready to stop the "small steps" policy?

At the beginning of the month, the Fed validated its policy of small steps by unanimously voting for a 25bp rate hike and by adding that several rate hikes will be necessary to reach its terminal rate. At the same time, the ECB finally hit hard with a 50bp rate hike and also hinted at an additional series of rate hikes. Against all odds, it was the US employment figures that emerged as the major surprise for February. With more than 500,000 new jobs created and the unemployment rate plunging to 3.4%, the US economy is in great shape! The numerous and significant rate hikes done by the Fed in 2022 had had no impact on the unemployment rate.

The disinflation process came to a halt. If the current trend were to continue, we could expect the Fed to press hard (again) on rate hikes and stop - at least temporarily - its policy of "small steps" which consists of raising rates by 25bp increments at each FOMC. So, is a 50bp rate hike back on the table for the March meeting? This is all the more likely since, historically, during periods of disinflation, the Core PCE (the inflation measure favored by the Fed) falls 30% less quickly than the headline CPI (the one closely watched by market participants and the general public). Fed funds will probably be closer to 6% than 5% in the coming months, raising the question whether the US economy will be resilient enough to withstand the shock.

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The January bull market fizzled out

If Fed funds were to go above 5.5%, should we revise our recession probabilities? The strength of the US economy will be tested despite its robust labor market. This leads us to forecast the continued inversion of the yield curve with the 2-year yield struggling and the 10-year yield likely to go back to the 4% level, paving the way for a 100bp inversion.

We were skeptical at the beginning of the year: fixed income markets were moving too fast and too far. Today, it is critical to remain cautious, unless the objective is to build "Buy and Hold" portfolios with a fixed maturity. In such a context, we take advantage of 2-year real rates above 2% from a "buy and hold" perspective (Buy & Hold: investors buying bonds with the aim to keep them till maturity). We continue to raise the duration of our Core portfolios at the margin and as long rates tighten. Finally, with regards to credit markets, we find euro-denominated corporate bonds much more attractive than the USD ones. The sharp correction in February, which wiped out much of the performance of a very good January, has two major advantages: 1- It offers a second chance to those who were still massively underweight in bonds at the end of 2022, and 2- it presents us with some very interesting opportunities, such as the ability to build "Buy & Watch" 3-year maturity EUR Investment Grade portfolios yielding now close to 4%.

3. EQUITIES
GOOD NEWS IS BAD NEWS!

After January that was dominated by renewed optimism in equities, February presented as a "back to reality" check. By mid-February, both the Eurostoxx 50 and the Nadsaq100 were posting a similar and outstanding performance of nearly 14% YTD. At the same time the S&P500 was up by 6.50% for the year and even the Chinese market (Hong Kong listed stocks) rebounded to around +12% YTD at the end of January.

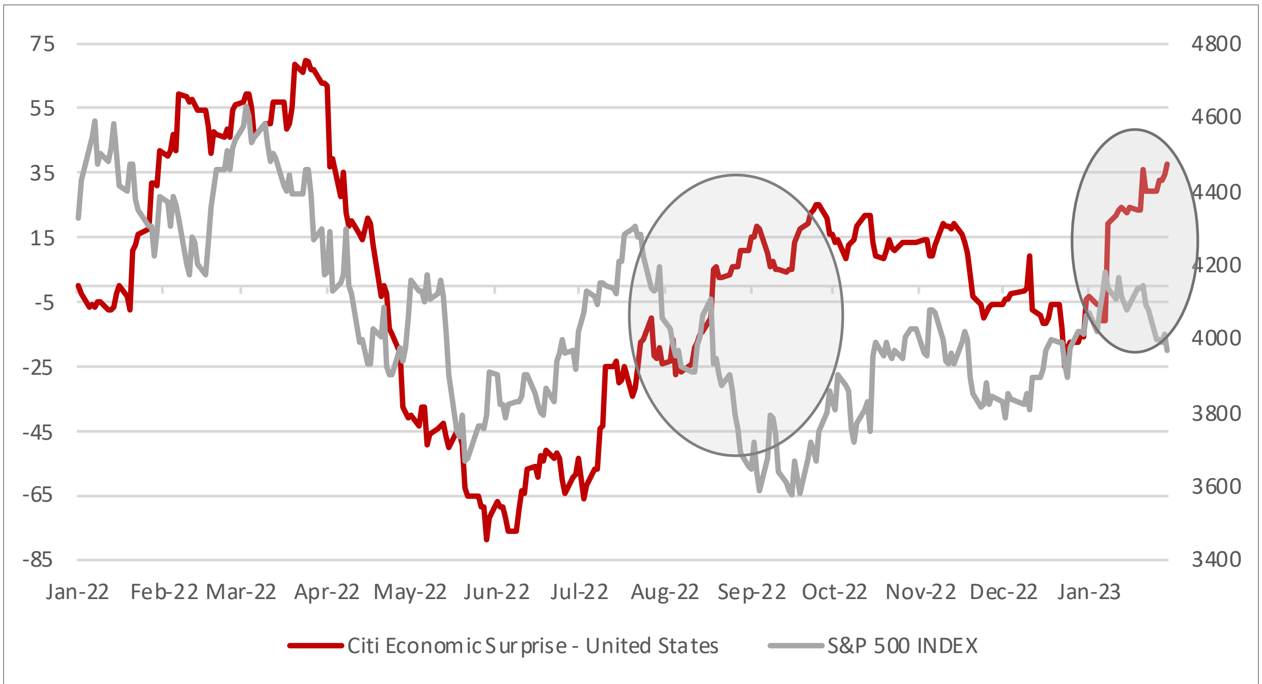
It looked like a new phase emerged in February... Volatility regained some ground and the VIX is now heading at speed towards its post-covid average of around 24% after having touched a 18% low in early February.

Investors are focusing again on macroeconomic data against the backdrop of J. Powell's still quite "hawkish" speech. US economy resiliency, coupled with a stickier inflation (as seen in the last monthly update) suggests continued rate hikes and higher than anticipated short term rates, thus implying a higher terminal rate for the FED funds of 5.4% by Summer 2023.

No surprise in such environment to see investors welcoming good economic data as bad news for equities, as it strengthens the US central bank's current hawkish stance.

Having a look at Q4'22 results, 95% of US listed companies have now released their quarterly results: Sales were broadly in line with expectations – which had been heavily revised downwards for 2022 – and earnings generally surprised on the upside – with the notable exception of the communication services sector and media companies / tel-

G2: CITIGROUP ECONOMIC SURPRISES US VS. S&P500



Source: Bloomberg, Banque Eric Sturdza, Jan. 22 to Feb. 23 cos which suffered the most. On a more negative note, guidances proved pretty cautious and this message translated as consensus of continued lowered earnings estimates. As a consequence, this year's performance looks pretty disconnected with earnings growth expectations, at least in the short term.

The payroll figures, inflation measures, US GDP data and retail sales, all surprised on the way up and contributed significantly to the rebound of the US Citi Economic Surprise Index. Last Autumn, the index's change in direction was concomitant with a downward move in the S&P 500 (see chart 2).

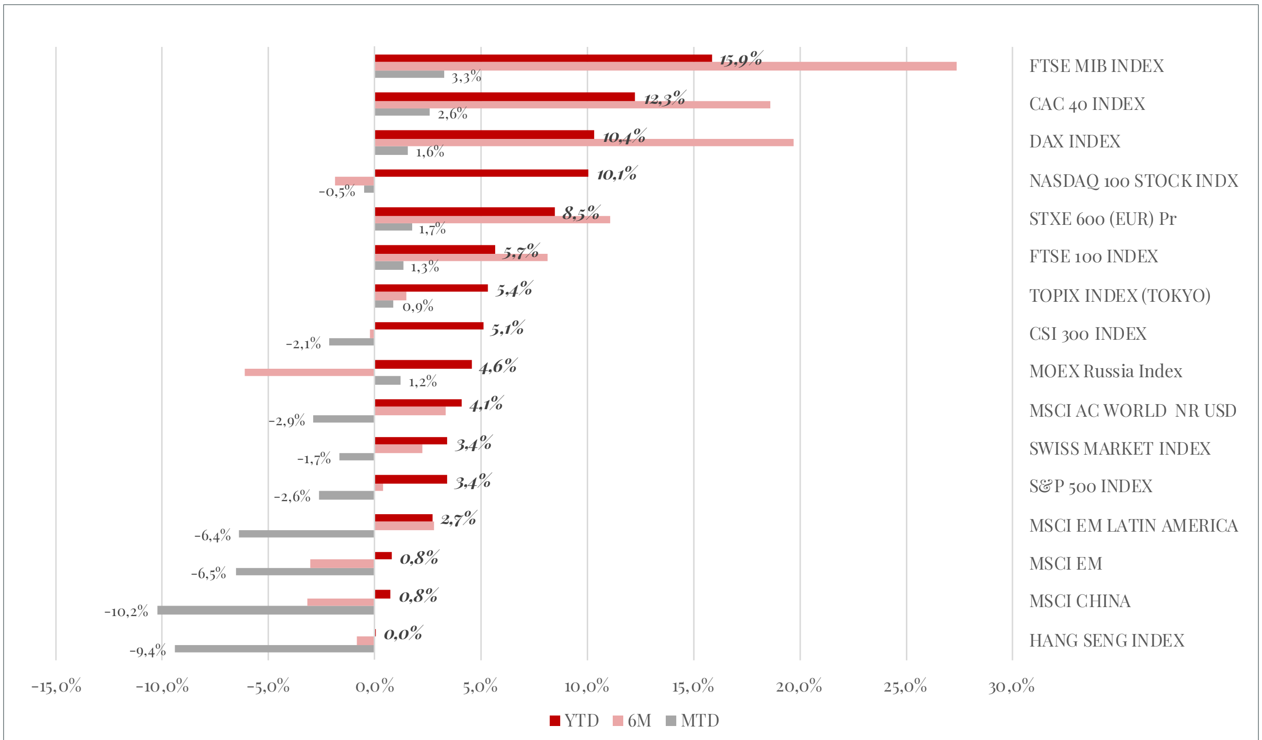
In Europe, the sound of cannon fire continues to impact inflation expectations (particularly energy) as Ukraine sadly enters a second year of invasion by Russia. The rhetoric remains the same but NATO still cannot convince Putin to sit down at the negotiating table. The Russian leader seems increasingly isolated, especially when he threatens to use nuclear weapons. A peace agreement between Kiev and Moscow still seems distant, while NATO countries have just ratified new sanctions against the Kremlin and strengthened their military and economic support for President Zelenski.

The reopening of China and the avoidance of an energy crisis so far have allowed the European economy, as we expected, to recover strongly and economic surprises are in full swing. The CAC 40 broke through all-time highs by exceeding 7,350 points on the Paris stock exchange, buoyed in particular by the luxury goods sector and the strong rebound in the automotive sector (STXE Auto&Parts +18.9% YTD).

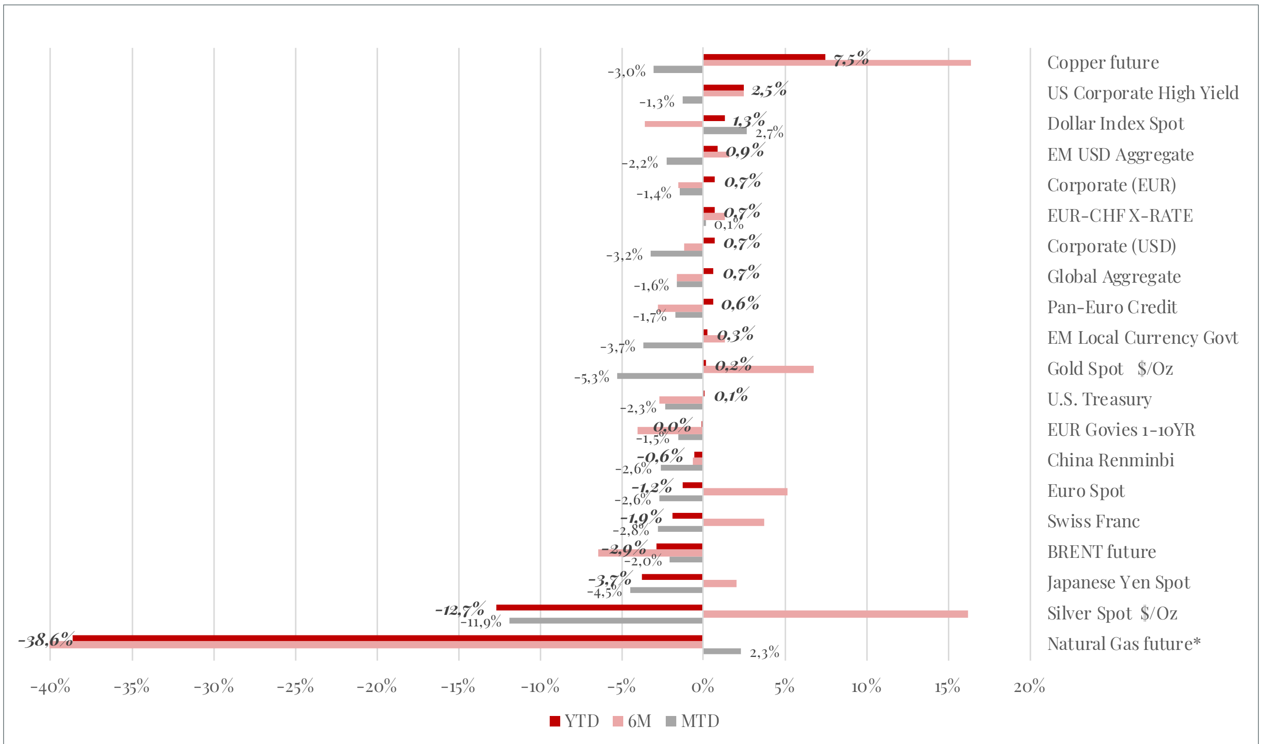
As the question of soft landing for the US economy or a recession resurfaces, we would not be surprised to see some profit-taking in equities and the start of a consolidation phase in the major developed markets.

5. PERFORMANCES

EQUITIES IN LOCAL CURRENCIES



FIXED INCOME, CURRENCIES AND COMMODITIES



Source : Bloomberg, Banque Eric Sturdza, 28/02/2023

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