BANQUE
ERIC STURDZA

MONTHLY NEWSLETTER
MAY 2023

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1. EDITORIAL
GROWING DIVERGENCE.

After a hectic March, this month's results appear almost boring: long-term rates ended almost unchanged at 3.52% for US 10-year Treasuries, the S&P500 and the Nasdaq100 are digesting their YTD appreciation.

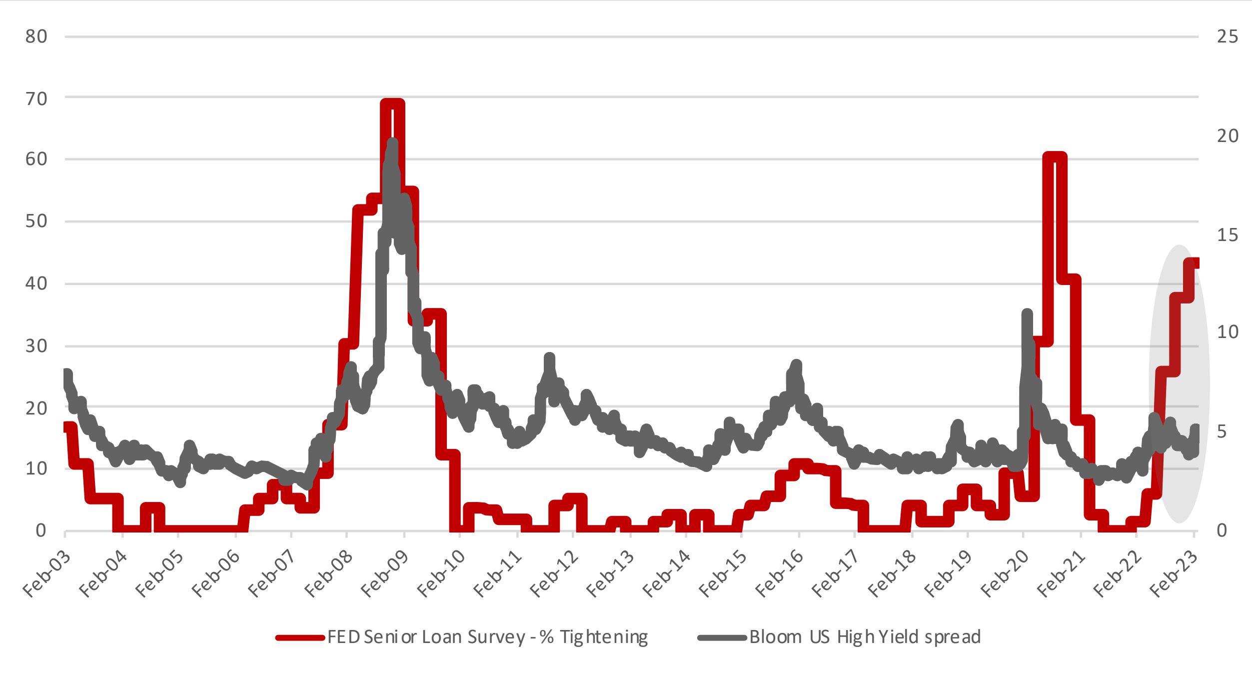
Relatively quiet financial markets contrast with the still gloomy macro outlook. Inflation remains stubbornly high in the United States and the eurozone. Make no mistake, the disinflationary trend seen in recent months is mainly the result of declining energy and commodity prices. This is most obvious with the US consumer price index (CPI), which excluding energy and food (5.6% year-on-year at the last release), outpaced headline CPI (5.0% YoY). This is all it took for market expectations to change drastically: the Federal Reserve's benchmark interest rate is now expected to peak at 5% or slightly above, and a first rate cut may come as early as in H2 2023. The discrepancy between the Fed's speech and market expectations is perplexing.

The earnings season that started a few weeks ago also illustrates another discrepancy. While most companies are posting better-than-expected results, this is against a backdrop of analysts, guided by company managements, who have significantly reduced their forecasts ahead of quarterly results. As such, the S&P500's earnings per share (EPS) are now expected to decline by 10% in 2023. The prospect is far from appealing from a fundamental atandpoint, especially considering the US market's high valuations. And yet, with a rise of more than 20%, the Nasdaq100 has seen one of its best ever starts of the year. Looking more closely, we see that the gains are fragile: The eight largest positions in the index account for nearly half of its capitalisation, and explain around 75% of its performance. Such concentration – albeit to a lesser degree – is also found in Europe.

The Nasdaq100's gains are fragile: The eight biggest stocks account for around 75% of its performance.

Finally, just a few weeks ago, the collapse of Silicon Valley Bank and Signature Bank, as well as the forced takeover of Credit Suisse by UBS, revived the wildest fears about the banking sector. Swift action by the authorities, first and foremost frin the Fed, reassured investors and avoided a wave of bank runs. As an illustration, the credit default swaps (CDS) of major European banks – which measure the premium paid to hedge against an issuer's default risk - have tightened almost back to normal. Far from facing significant deposit outflows, JPMorgan, the leading US bank, reported that it attracted USD50 billion in new deposits over the quarter. Finally, Unicredit repaid one of its AT1 bonds, in what can be considered as a real test for the asset class, which few expected to recover after the wipe-out of USD17 bn worth of Credit Suisse AT1 bonds. Once again, the market consensus moved from extremely negative to blissful optimism. While we did not subscribe at first to March's 'gloom and doom' scenario, we also remain skeptical that the US banking crisis was fully resolved. Moreover, the announced failure of First Republic Bank, another regional bank with a 200bln balance sheet size, reminds us that the Fed has not finished 'breaking things,' and that the crisis affecting regional banks is probably not over. The risk of recession materialising as a result of a credit crunch and tighter financial conditions is real (see chart 1).

G1 : FED LOAN SURVEY - PERCENTAGE OF BANKS INDICATING THEIR INTENTION TO TIGHTEN CREDIT CONDITIONS VS. HIGH YIELD SPREAD



Source: FED, Banque Eric Sturdza

Macro and microeconomic data are starting to materially diverge from financial markets' reactios. This leads us keep a cautious bias in our allocations: maintaining our diversification, using favorable volatility to strike new equity hedges, and keeping a balanced exposure to growth stocks that are buoyed by falling interest rates and others less sensitive to this theme.

2. FIXED-INCOME

"REAL" FED FUNDS RATES ARE POSITIVE AGAIN.

Fed: a final hike on May 3?

The PCE inflation figures released at the end of March were generally in line with expectations, although sequentially slightly lower due to the previous month's revisions. As PCE (Personal Consumption Expenditures) remains the Fed's favourite measure to track inflation, it is worth looking at the PCE Deflator and Core PCE, respectively at 4.2% – latest date released on 28/4 – and 4.6%. When compared with the Fed funds that are averaging 4.75%-5% since March 2022, they are already in positive territory in real terms, if we use Core PCE as a reference. We are getting we are getting inexorably closer to the terminal rate.

The Fed's balance sheet reduction reassured financial markets. Investors inferred that the Bank Term Funding Program (BTFP), the new liquidity tool created after SVB's failure, was probably a one-time event. More disturbing, we notice that market participants now expect Fed funds to peak and then fall shortly after, whereas, barring a major crash in the financial system, a nine-to-18-month pause would be a more normal path before a first rate cut. If financial markets and central bankers are right, and the crisis is under control after the SVB and Credit Suisse episodes, there is no reason for the Fed to lower rates immediately after hitting its peak. Only a recession or a credit crunch would demand a cut.

Don't confuse corporate and bank subordinated debt

The upturn in more risky segments of fixed income does not call into question a cautious approach. In our core investment vehicle, we have preferred duration risk through long-dated sovereign bonds to credit risk and high-beta credits. Although undermined during the confidence crisis that shook the banking industry in March, the yield curve's invesion has not reversed. If the Fed does not clearly signal a pause in its restrictive policy at the next FOMC meeting, the 2-5 year yield curve segment will be come under pressure, the 30-year note, much less so. The latter will sooner or later have to converge to a level compatible with a growing risk of recession and credit crunch.

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We always considered that the major hurdle to the development of the corporate hybrid debt was a confusion with bank subordinated debt. The Credit Suisse debacle will at least have served a purpose, as everyone now knows the difference between the two. In terms of market reaction, corporate hybrid debt felt suffered for 48 hours following the now infamous deal that saw Credit Suisse absorbed by UBS. Then, once the wheat was separated from the chaff, corporate hybrid debt rebounded at the end of March and continued to rise in April.

3. EQUITES

SO FAR SO GOOD

This year never ceases to surprise. Lower economic forecasts, an expected drop in EPS, and geopolitical upheavals have all failed so far to impact the resilience of equity markets.

Is this resilience unshakeable?

First of all, it is important to identify the reasons that may explain such a situation. Equity markets' steep decline in 2022 may have been exaggerated but helped to reduce valuations to historically low levels in Europe and Asia. The Nasdaq also widely underperformed broad indices. This year is quite a different story as the Nasdaq rose sharply, helped by a few heavily-weighted stocks. Some of this year's performance can be attributed to a catch-up trade.

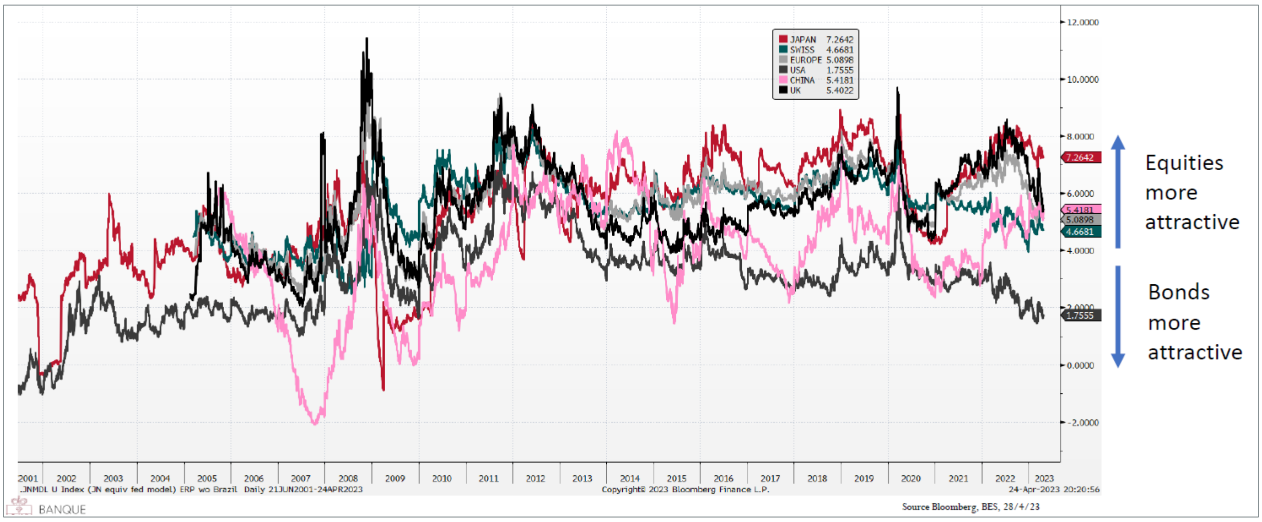
In addition, the earnings season underway in the US is 'artificially' reviving some hopes. Indeed, many companies reported better-than-expected results but did so thanks to substantially lowered expectations.

One of the few collateral benefits of the recent US banking crisis may be a less hawkish central bank, and potentially a plateau in US short-term rates. In the Euro area, headline inflation has started to fall, even though core CPI remains stubbornly high at 5.7% (March reading), and has not yet reached a plateau.

Some economic indicators are reassuring. Manufacturing Purchasing Managers' Indices (PMI) have decline, but services, which represent two-thirds of European gross domestic product, are higher and still expanding. China's recovery is also disproportionately more beneficial for European companies than those in the US, as seen in the luxury goods sector.

Assessing the relative attractiveness of equties versus fixed income, we look more closely at the spread between earnings yield (inverse of the price-to-earnings or PE ratio) of various equity markets and long term bond yields. It appears that equities remain quite attractive compared with long term rates in

G2: EARNINGS YIELD (P/E INVERSE) MINUS BOND YIELD (10YR GOVERNMENT BOND)



Source: Bloomberg, Banque Eric Sturdza many parts of the world, particularly in Japan, Switzerland, Europe and China. The situation looks less favorable in the US as valuations are high, with lower earnings yield, and long-term rates that reset higher last year.

Why remain cautious?

On the economic front, a more pronounced slowdown or even fears of a recession could trigger a renewed risk aversion and prompt investors to take some profits, especially as equity markets unexpectedly rebounded strongly.

More persistent inflation could prompt the Fed to become more hawkish again. Even if the US central bank were to raise short-term rates less than feared earlier this year, the plateau phase could last longer than currently expected.

On the volatility side, the Move Index (implied volatility of options on Treasury bills) surprisingly indicates a greater stress than the VIX, the implied volatility reference for equiy makerts. Historically, the two indices tend to move in tandem with implied volatility on fixed income lower than the historic sensitivity of bond managers.

Access to credit by companies and households is tightening on both sides of the Atlantic. In addition to higher interest rates, which severely limits borrowers' ability and willingness to take on new debt, the stress caused by the SVB and then First Republic in the US, accentuated by the collapse of Credit Suisse, is pushing financial institutions to become more selective on the loans they are ready to grant.

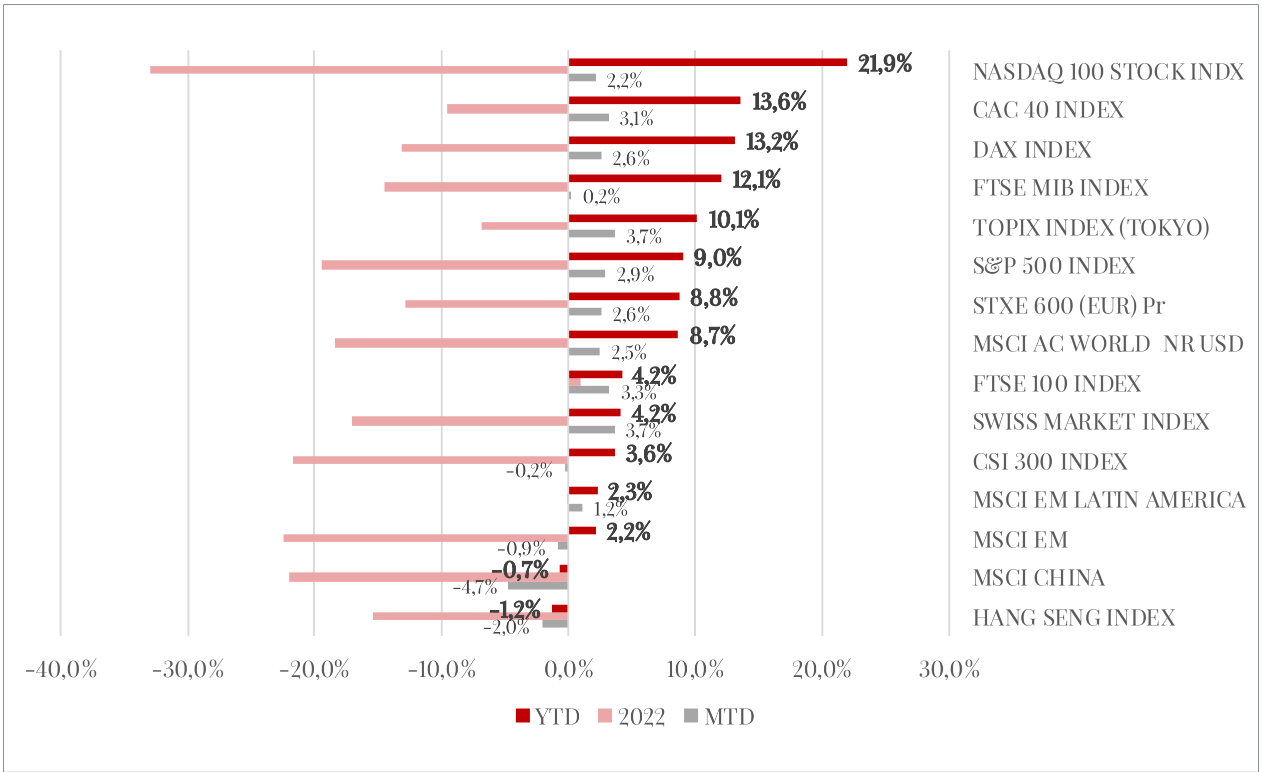
At the geopolitical level, the world is certainly seeing major changes. The influence of the West, led by the US, may be diminished in favour of a multipolar world. It seems difficult to count on the newly-announced candidacy of Joe Biden for the 2024 presidential election, certainly if he faces Donald Trump, to provide the impetus for change. In such a polarised country, the lack of alternatives capable of building a democratic renewal could continue to weaken the values of the Western world.

We therefore remain cautious as the global economy continues to contract. Nevertheless, we are taking advantage of the market's rise, thanks to our structurally long positioning in the asset class, and we favour alternative investments, notably through our 'long/short' strategy and some structured products. We are also using episodes of low volatility to adjust our equity hedging strategy and extend its duration a little further.

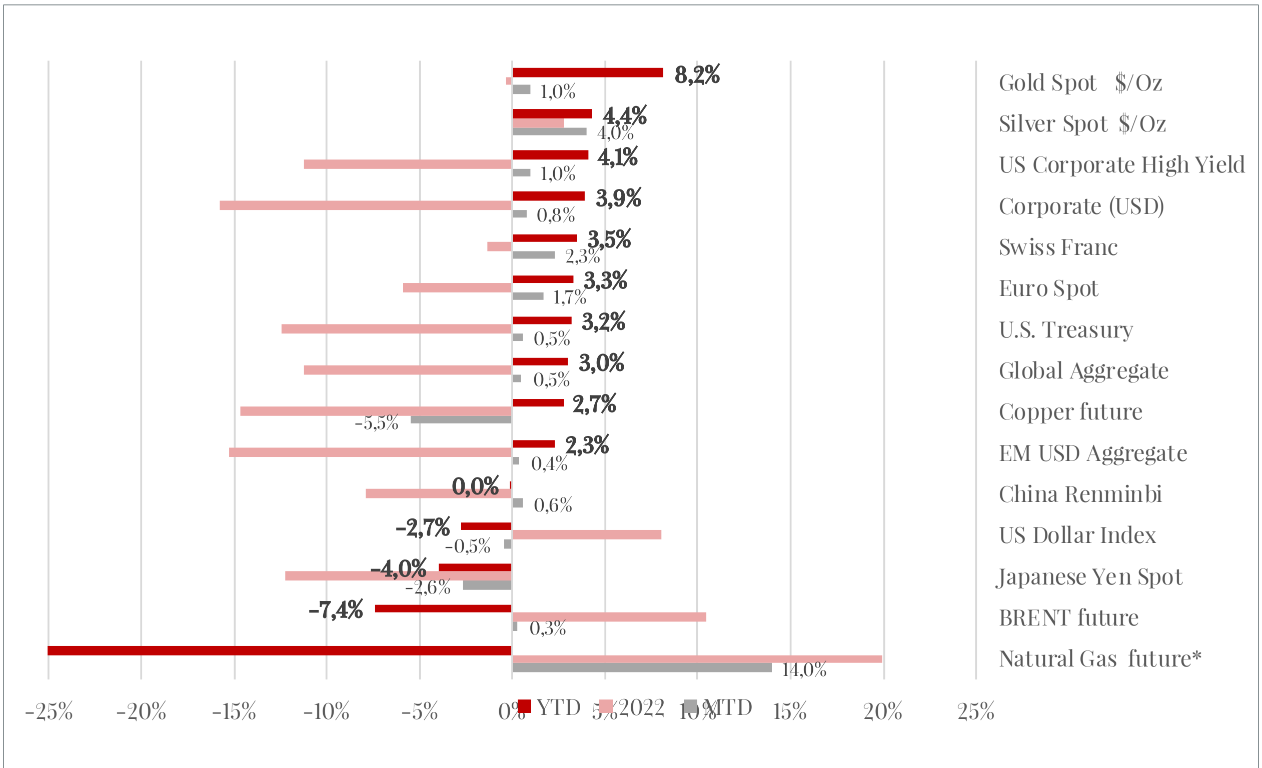
We remain cautious on equities and continue to favour a blended approach, preferring both investments in selected value stocks and quality growth segments in our portfolios. Our focus remains on Asia (China, Japan and India). We prefer an asymmetric approach through the use of derivatives (long/short strategies or structured products).

5. PERFORMANCES

EQUITIES IN LOCAL CURRENCIES



FIXED INCOME, CURRENCIES AND COMMODITIES



Source : Bloomberg, Banque Eric Sturdza, 28/04/2023

** Natural Gas -39.6% YTD, +20% 2022*

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We are renovating our main building. In the meantime, we are happy to welcome you in our temporary offices.

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