BANQUE
ERIC STURDZA

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JUNE 2023

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** Bill Gates*

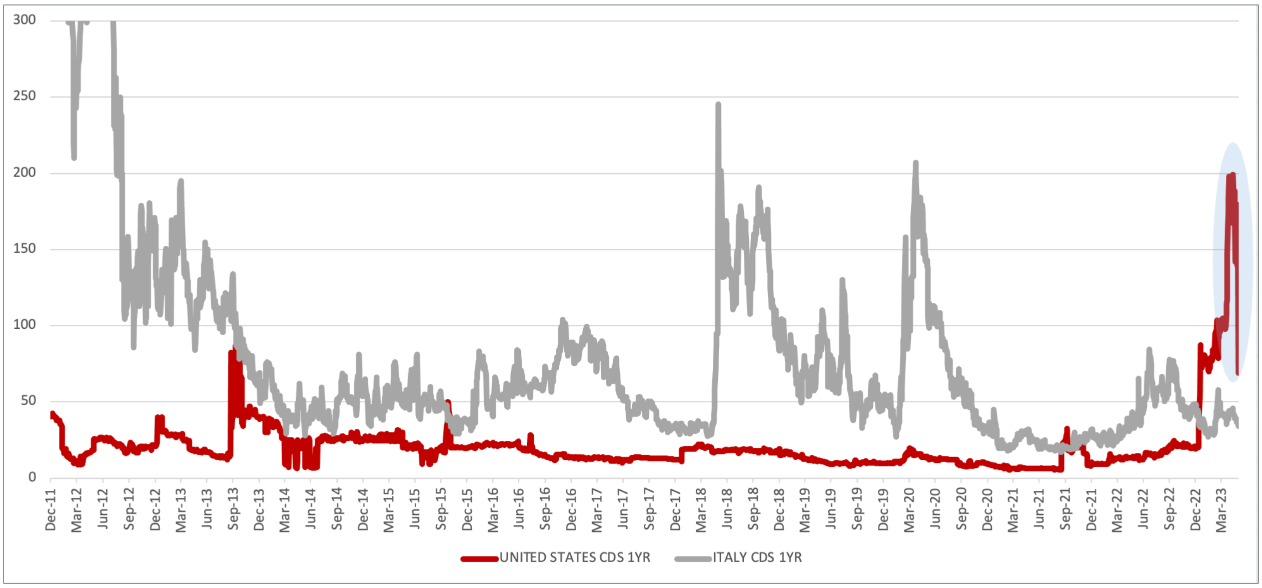
1. EDITORIAL

*"WE ALWAYS OVERESTIMATE THE CHANGE THAT WILL OCCUR IN THE NEXT TWO YEARS AND UNDERESTIMATE THE CHANGE THAT WILL OCCUR IN THE NEXT TEN." **

This quote from Bill Gates, itself inspired by Amara's law on the effects of technological changes, echoes the events of May. Indeed, the US markets ended the month on a positive note, buoyed by the hope of a last-minute deal between Republicans and Democrats to raise the US debt ceiling, and by the hype surrounding Artificial Intelligence (AI) following the stellar results released by Nvidia, the leading chip manufacturer.

The debt ceiling mechanism, which was established in World War I, defines the leeway given to the US government by the US Congress to issue debt. Since 1960, Congress has acted 78 times to temporarily extend, raise or redefine the debt limit. If lawmakers failed to rein in a ballooning public debt, it has increasingly been used as a political lever in the US's polarised politics. According to Treasury Secretary Janet Yellen, the US reached the maximum additional money they can go borrow in January, leaving the nation with no other option than to rely on temporary quick fixes to meet budget requirements. After fierce negotiations, Democrats and Republicans managed to reach an agreement a few days before the deadline. Based on the proposed plan, Republicans swapped a two year extension of the debt ceiling for cuts in discretionary non-defense budget spending, Democrats agreed to cuts that would moderately affect social programmes and spare recently funded bills such as the Inflation

G1 : US AND ITALY 1-YEAR CREDIT DEFAULT SWAPS.



Source : Bloomberg, Banque Eric Sturdza

Reduction Act. Once fully approved by Congress, the plan would potential avoid a 'technical' default.

While equity markets remained relatively indifferent to this issue, Treasury bills with maturities close to the X-date saw their yields widen significantly, and the 1-year Credit Default Swap (CDS), the insurance premium to pay to hedge against a US default, rose sharply (see chart 1). Last-minute approval is now as we are writing widely expected, avoiding the risk of a volatility shock similar to that of 2011, which ultimately led to the downgrading of the US sovereign debt rating.

In the short term, the risk of a potential default may have been overestimated, the uncertainty surrounding the debt ceiling and its long-term consequences are far from neutral. Once fully approved, the Treasury department will have to issue debt to build new liquidity provision, threatening to provoke crowding-out phenomena and dry up liquidity even further. Longer term, it is the US dollar's credibility, faith in the US and its assets that could be seriously challenged with repeated drama and debates on the Debt Ceiling.

It's also difficult to review last month without mentioning Artificial Intelligence (AI) and its impact on financial markets. After the ChatGPT frenzy earlier this year, and the buzz created around the integration of AI by the FAAMG (Facebook/Meta, Apple, Amazon Microsoft, Google/Alphabet), it was Nvidia's turn. Late in the month, the company reported stellar results with booming and better than expected sales due to an increased demand for its chips (widely used for AI applications), it was largely enough to trigger a buying frenzy on AI-related stocks. Nvidia thus joins the very selective club of companies with market capitalisations in excess of USD 1 trillion, and its valuation at almost x23 of expected 2023 revenues leaves little room for error.

The prices of FAAMG stocks identified as AI's big winners are rocketing, hiding a sad reality on the US market: excluding the FAAMG, Nvidia and Tesla and the concentration issues related to them, the S&P500 has barely performed since the start of the year (S&P500 Equal Weighted -0.6% year to date). Even if AI could become the fourth industrial revolution, the disconnect between stock prices and current economic applications remains significant. Let's not forget that, while no one dares nowadays to question Jeff Bezos' founding vision of e-commerce, it took Amazon nearly seven years of stock market volatility before its share price returned to its dot-com bubble peak.

In this environment, we maintain a relatively cautious approach: Yes, technical default should be avoided. Yes, AI could become the fourth industrial revolution. But complacent markets, concentration issues and too much of a hype around AI lead us to adopt a more cautious tactical balance, with a more favourable long term view and selective investment opportunities.

2. FIXED INCOME

DURATION IS BACK (AT LEAST PARTIALLY)

US regional banks, a sword of Damocles

In theory, the US Federal Reserve (the Fed) should have reached the end of its rate hike cycle, and now be considering a long pause before easing for the first time in twelve to eighteen months. However, it could also maintain a restrictive policy, as suggested by Jim Bullard of the St. Louis Fed, who has called for two more rate hikes. Indeed, despite what look like rather encouraging inflation statistics at first glance, consumer price indices excluding food and energy are still rising. What's more, price pressures in the services sector continue to rise inexorably, a trend that can only be halted by a significant increase in the unemployment rate (combined with a slowdown in wage growth). Conversely, the rate cuts anticipated by fixed income markets from the end of this year correspond to a recession and/or credit crunch scenario, accompanied by major problems in the US regional banking sector. At this stage, it would be unreasonable to rule out any of these scenarios (rise, pause or fall), as they correspond to the different developments in the US economy that we can expect to see in the second half of the year.

The issues with regional banks do not appear to be similar to the large-scale systemic risk that we experienced with Lehman Brothers, or was narrowly-avoided with Credit Suisse. However, these medium-sized banks are the lifeblood of the 'real' American economy, the small and medium-sized businesses that continue to hire and offer double-digit pay rises to their employees. These businesses are the real driving force behind strong growth, historically low unemployment and rising wages. These companies do most of their business with regional banks. This is why the current crisis must be taken very seriously, as any worsening would ultimately put the US economy in difficulty.

At this stage, it would be unreasonable to rule out any of these scenarios: rise, pause or fall of short term interest rates.

Easing credit risk in favour of duration

We have therefore decided to protect ourselves by slightly reducing our positions in the most volatile credits in our main investment portfolio. This is only a temporary reduction, however, as a precautionary measure. The outstanding performance of credits (senior and subordinated) since the start of the year has also prompted us to take some profits in our core investment vehicle.

At the same time, we favoured duration in our main fund, which could finally regain its role - lost in 2022 - as a natural and effective hedge against possible jolts in more volatile markets such as corporate debt and equities.

In short, our portfolios hold a little less credit and a little more duration in a period of growing uncertainty, in order to effectively manage our risk exposure within a strategy that remains broadly unchanged over the medium-to-long term.

3. EQUITES

ARTIFICIAL PARADISE OR INTELLIGENCE?

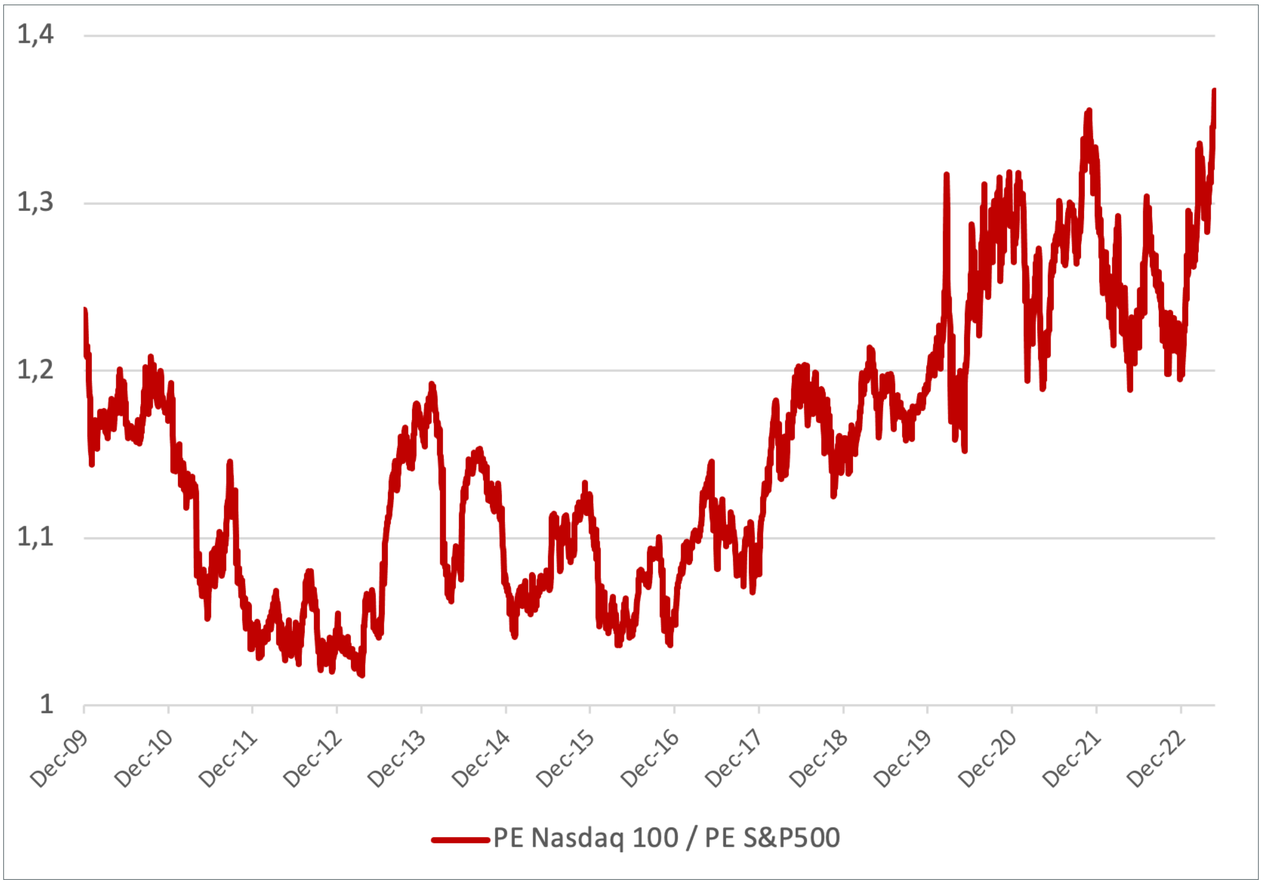
The month of May confirmed the upward trend observed on the markets since the beginning of this year, gently rocked by some volatility. The rise continues, with the VIX averaging 17.5% in the US and 18% in Europe (V2X index) over the period. In other words, for the time being, even the issue of the US debt ceiling has not worried the asset class, which seems unshakeable, particularly in the US.

Equities continue to rise, most notably in the US, where the S&P 500 has just broken through its high for the year at around 4,200 points.

The mega tech or communication services' stocks are leading the way, with the Nasdaq 100 posting sound performance of +8.5% month on month, and +31% over the year at the time of writing. It is worth noting that the high concentration in a few large stocks skews the results. The recent rebound in US equity indices therefore remains fragile, as it appears to be sustained by only a handful of stocks.

A rapid analysis of the valuation gap (price/earnings based) of the S&P500 with that of the Nasdaq 100 clearly shows that it remains substantial, and that technology and communication services command a premium not seen since the Great Financial Crisis of 2008.

G2 : PE SPREAD – NASDAQ100/ S&P500



Source : Banque Eric Sturdza, Bloomberg

The market's optimism was largely explained lately by the frenzy over Artificial Intelligence. Interestingly enough, it came at a time when growth and development prospects seemed pretty muted otherwise in the technology sector. One by one, companies are unveiling applications of this digital revolution. Machine learning, deep learning, computer vision and natural language processing are all being launched at breakneck speed.

ChatGPT has triggered an upheaval and panicked the most recalcitrant, who see in this technology the programmed end of humanity. The application's monopoly was short-lived, however, and speed of adoption is accelerating: after the partnership signed between Microsoft and OpenAI – the software editor of ChatGPT – it took only a few days for Alphabet, the internet giant - which had already made great strides in its AI projects in recent years – to release its Bard AI-engineered assistant, which is already capable of handling live news.

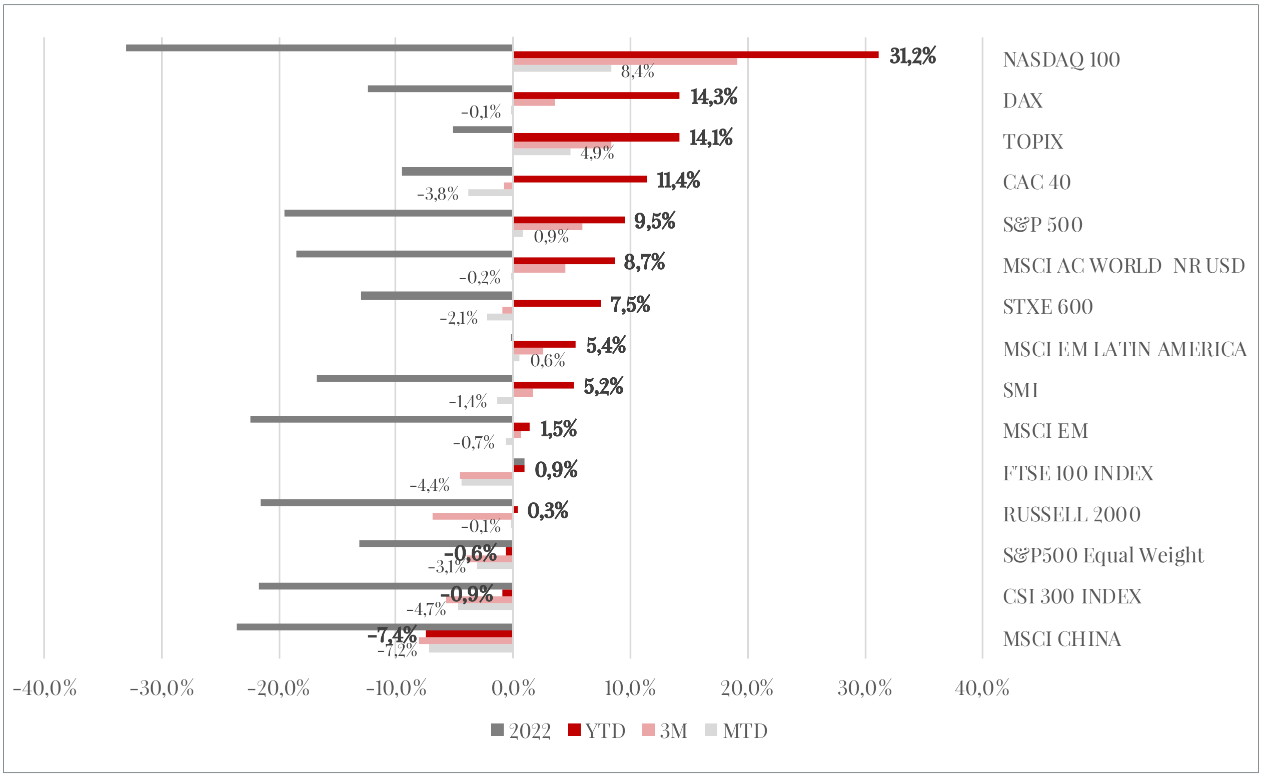
While it's still too early to understand all the implications and developments of this major breakthrough, we understand the need for a firm legal framework for this technology. Limits are likely to be imposed over time, even though the technological train has already left the station.

In the meantime, growth forecasts and earnings revisions are being revised up for these stocks, justifying also the increased popularity of these stocks among investors. This also explains why it represents the main contribution to the US market's rise in recent weeks whereas performance has been more muted in other sectors, and in the rest of the world. This technology is also creating opportunities in a wide variety of industrial sectors. Analysts are adding very positive momentum for the sector by favorably revising their earnings expectations, mainly for the already visible part of this revolution, i.e. demand for processors, as evidenced by Nvidia's share price (+166% since the start of the year).

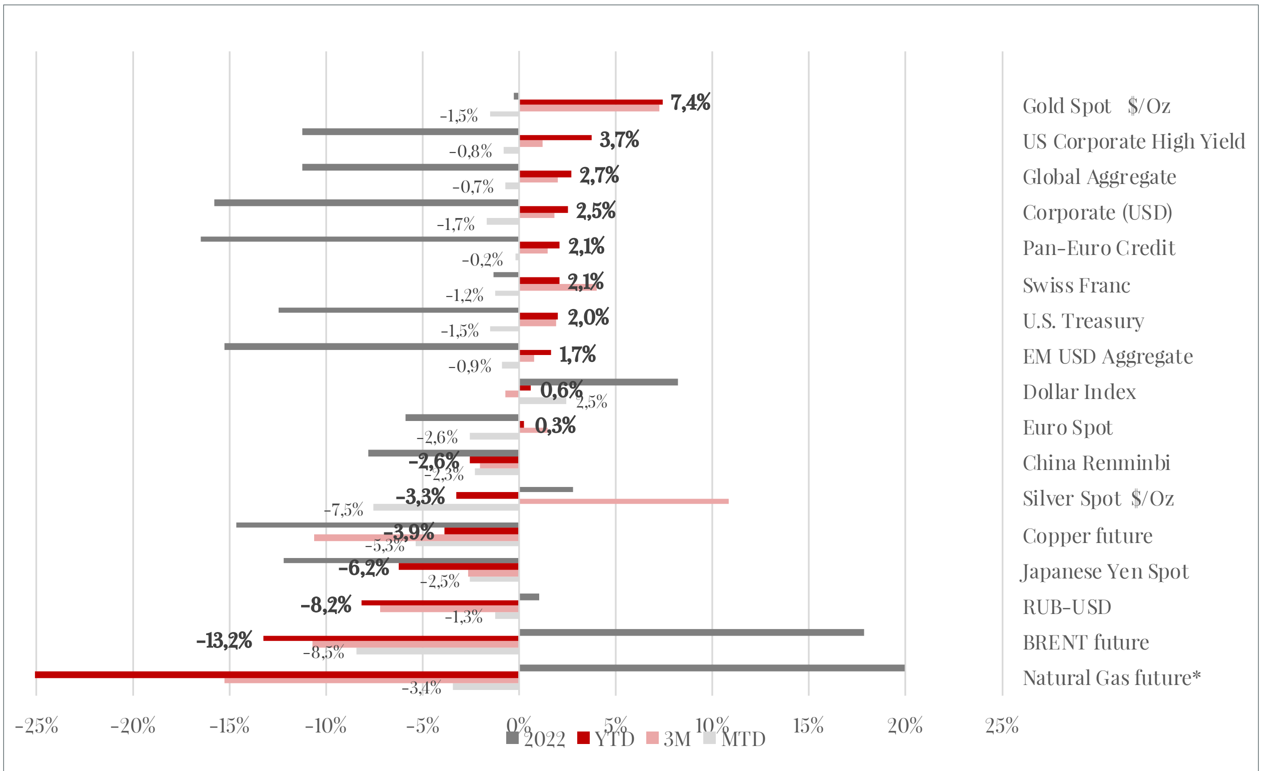
Even if the major topics that are inflation and to a lesser extent the Debt Ceiling remain in investor's minds, the next few days will be decisive in setting the pace for the months ahead. We continue to selectivity, diversification by geography and sector and active management in this market. As equity investors appeared quite complacent, we took advantage of favourable market conditions and low volatility to hedge part of our portfolios against the risk of a downturn in the asset class.

5. PERFORMANCES

EQUITIES IN LOCAL CURRENCIES



FIXED INCOME, CURRENCIES AND COMMODITIES



Source : Bloomberg, Banque Eric Sturdza, 30/05/2023

**Natural Gas future: -41.9% YTD*

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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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