BANQUE
ERIC STURDZA

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SEPTEMBER 2023

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1. EDITORIAL
A SUMMER OF PARADOXES…

Nervous investors often look ahead to August with some anxiety. In markets where liquidity is limited due to a lack of participants, a single disappointing economic statistic or a piece of information widely reported in the media can have a disproportionate impact.

In this respect, this August was no exception. Indeed, it's hard to ignore the anxiety-inducing nature of media coverage predicting the upcoming economic collapse of China against the backdrop of a severe real estate crisis. While the sector's difficulties are very real, they are not new and have their roots in the past excesses – over-investment, the excessive leverage of real estate developpers, speculative bubbles – but also in the drying-up of finance channels for real estate developers resulting from the implementation of the Golden Rules policy by the Chinese authorities. After the well planned bankruptcy of Evergrande in 2021, Country Garden, another major Chinese real estate developer, is now a source of concern. Against this backdrop, the performance of Chinese markets remains very disappointing, but is far from being as catastrophic – except in the real estate sector – as the prevailing media coverage might suggest. Some international companies whose fate is closely linked to China's destiny even continue to post impressive stock or US champions returns. Just look for example at luxury goods stocks such as Tesla and Apple, for whom China remains the biggest international market after the US. This is one of the paradoxes of the current situation.

G1 : US 30YR YIELD

Source : Bloomberg, Banque Eric Sturdza

Another way of looking at this is to consider the Chinese banking sector. In a classic real estate crisis, banks are usually amongst the first to feel the pain with mounting bad loans and loan losses that translate into significantly lower share prices. From this perspective, Chinese banks' stocks are far from showing extreme stress levels, and even have the luxury of outperforming their American counterparts, who are also facing their own real estate challenges and are struggling to recover from the Silicon Valley Bank debacle.

The second, more classic paradox reflects what Anglo-Saxons call "bad news is good news". Indeed, the flow of bad news from China reinforces the likelihood that the Chinese authorities will do more to support its economy and restore investor confidence. Lowering stamp duty on Chinese equities and on down-payment requirements for first time buyers add to that and helped Chinese equity markets stabilize and rebound at the end of the month.

Far from falling, US long-term yields have risen, with US 30-year even approaching 4.50%, a level not seen since 2011.

The third and perhaps the most surprising paradox is the reaction of safe havens over the same period. Let's not forget that, when the environment becomes perceived as riskier, investors' first move is to step back from risky assets such as equities, to favour assets perceived as safer such as gold, long term rates and US Treasuries. While the first part of the equation worked in August, with a slight consolidation of equity markets, the second part was less obvious. Indeed, far from falling, US long-term yields have risen, with the US 30-year even approaching 4.50% during the month, a level not seen since 2011. This is a far cry from the typical fall in long term rates experienced in crisis scenarios.

Many theories have been put forward to explain this paradox, including some legitimate ones: A situation on the inflation front that has not entirely normalized, justifying "higher for longer" rates and not just on the short end; US macro data that lend further credence to the soft landing thesis and remove the spectre of recession for this year; a new balance to be found for long term rates to continue attracting international investors, first and foremost the Japanese; a downgrading of the US credit rating that would justify an additional yield premium; or quite simply that the market does not believe in the scenario of an imminent Chinese collapse that the media are just stirring it up.

On these various points, we share the following convictions as we head into the autumn. Yes, the inflation peak is probably behind us, but that doesn't mean that inflation is under control and that the Autumn may not hold a few nasty surprises. Yes, the most likely scenario in the short term is that of a US soft landing. However a recession cannot be ruled out in the medium term though, in which case the duration we are loathing today could prove useful. Yes, China is disappointing, the economic slowdown is real and the real estate crisis a true risk, but these factors also offer hope, encouraging the Chinese authorities to do more. Finally, while an economic slowdown seems largely priced in for Chinese assets, this is far from being the case for all assets, some of which continue to be priced for perfection. For us, these are all points to watch out for as we head back to work.

2. FIXED INCOME

JACKSON HOLE: HAWKISH BUT NOT EXCESSIVELY SO.

Soft landing = additional rate hikes

The Bank of Japan (BoJ) modified its Yield Curve Control (YCC) policy by raising the ceiling on the 10-year JGB from 0.5% to 1%. Such a move by Japan's central bankers was inevitably supposed to push US long term rates above 4% and, in turn, the German Bund to 2.6%. That's exactly what happened, but if we look closely, the rise in long rates took place just before the BoJ meeting. US 10 and 30-year Treasuries did rise above 4%, and as early as July 27, following the release of the 2nd quarter GDP at 2.4% QoQ instead of the expected 1.8%. Admittedly, the uptrend gained momentum in early August after the BoJ's infamous decision, followed by Fitch's decision to downgrade the US rating from AAA to AA+. But the hard truth is that the trigger for such a move was the GDP figure, which further validated the soft landing scenario, de facto removing the spectre of a recession.This was confirmed by Jerome Powell at Jackson Hole: the inflation issue has still not been fully resolved, the Fed will have to continue its policy of rate hiking, and the macroeconomic figures confirming the resilience of the US economy encourage it not to hesitate. However, the tone used by the Fed in Jackson Hole was less aggressive than some might have feared. We must therefore consider that the recession scenario has not been totally ruled out. It is simply considered as a low-probability event by the Fed and market participants. Under these conditions, a readjustment across the yield curve was inevitable.

Fitch rocks the boat

Rating agency Fitch has made good on its threat and withdrawn the AAA rating from US sovereign debt. This in no way affects our perception of the quality of US Treasury bonds, nor our management of them. For many years now, we have assigned the lowest rating to each bond we hold, rather than an average rating. In our portfolios, Treasuries have been AA+ since August 2011. We have always believed that this "worst of" approach is more sincere than any kind of average rating assessment. That Fitch has taken this step, after the endless debates surrounding the debt ceiling and, above all, after noting the monstrous size of US government debt and the growing fiscal deficit, is neither a surprise nor a major event. We just take note that the average US debt rating used by the markets has just converged with the one we've been using since August 2011.

3. EQUITIES

ALL THAT GLITTERS IS NOT GOLD...

As the earnings season draws to a close, it's time to take stock of what has been a very special year for equity markets. The results are quite positive, if we look primarily at the beat ratio (companies reporting better-than-expected results vs. lower than expected ones), or at the absolute surprise level in both sales and earnings. It's the latter figures that surprise the most and partly justify the relatively good performance of equities over the recent period: US companies have always been good at managing investors' expectations and then beat those expectations, but this quarter S&P500 companies, by reporting earnings per share that were on average more than 7% above expectations, achieved historic performance. However, while the surprises were impressive, earnings growth was far less so. It has to be said that, with an aggregate year-on-year EPS decline of nearly 6%, the S&P500 earnings season has been one of the worst over recent history. This weariness is also reflected in market reactions post results, more specifically for some of the "Magnificent Seven" (Apple, Microsoft, Meta, Amazon, NVidia, Tesla, Alphabet) that were the driving force behind S&P gains this year. While most of these companies published very good quarterly results, if not outstanding, investors were less than enthusiastic and the initial pop (if any) post earnings tended to fade away a few sessions later. It has to be said that, after the impressive gains registered by these stocks year-to-date, expectations are clearly set higher, so are valuations, leaving little room for disappointment.

Valuation levels remain high, particularly in the US, and call for a relatively selective approach. While some macro data is encouraging (such as

G 2 : S&P500 SUMMARY OF QUARTERLY PUBLICATIONS Q2 2023

			Earnings Surprise				Earnings Growth			
Sector	**Reported**		**+**	**=**	**-**	**%**	**+**	**=**	**-**	**%**
S&P500	**490**	**498**	**390**	**23**	**76**	**7,63 %**	**280**	**8**	**202**	**-6,18 %**
Materials	29	29	21	0	8	7,89 %	8	0	21	-29,25 %
Industrials	69	69	51	6	12	8,49 %	42	1	26	8,61 %
Cons. Staples	33	37	29	1	3	7,28 %	25	1	7	6,76 %
Energy	26	26	20	1	5	3,42 %	8	0	18	-51,42 %
Technology	78	80	69	6	3	7,50 %	48	1	29	3,47 %
Cons. Discretionary	50	51	42	0	8	19,55 %	33	1	16	32,67 %
Communications	22	22	20	0	2	7,59 %	15	0	7	14,39 %
Financials	59	59	43	1	14	7,21 %	35	2	22	5,63 %
Health Care	64	65	58	0	6	5,08 %	35	1	28	-27,39 %
Utilities	30	30	18	4	8	2,53 %	13	0	17	1,78 %
Real Estate	30	30	19	4	7	3,02 %	18	1	11	8,74 %

Source : Bloomberg, S&P, Banque Eric Sturdza, 30/08/2023

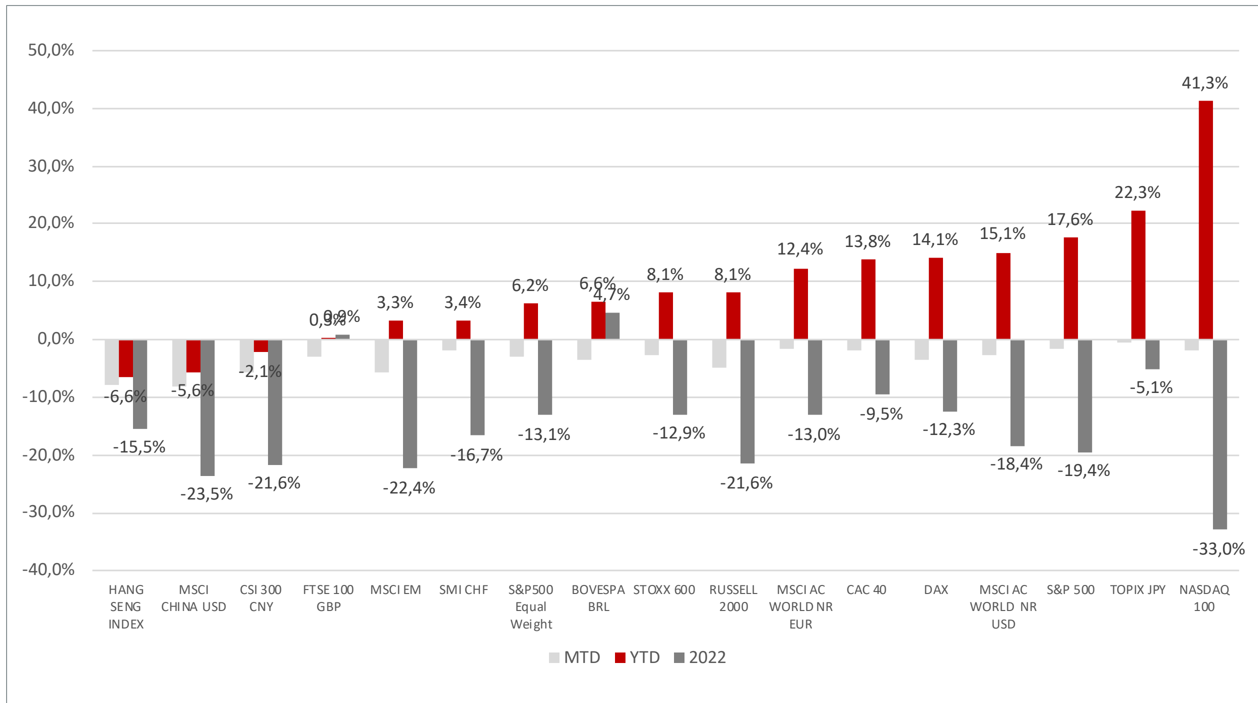
that arguing for a soft landing scenario in the US, with an economy that remains strong and resilient) other elements temper our enthusiasm and contrast with the rather rosy vision that this earnings season could have provided. China's slower-than-expected recovery raises questions, as does its still very fragile real estate sector. The geopolitical situation, particularly in Eastern Europe and more recently in Africa, remains a risk factor. Finally, inflation, which has not been completely brought under control, remains a threat.

Worryingly, purchasing managers' indexes (PMIs) remain very fragile, struggling to stay above 50, the threshold marking the difference between expansion and contraction. While services are proving fairly robust, this is far from being the case for manufacturing activities, particularly in Europe, where the composite PMI of 48.6 is dragged down by a very poor manufacturing PMI of 42.7, also reflecting the tough economic conditions Germany is facing. Finally, after years of dearth, investors now have reasonable alternatives to equities with USD quality bonds that are now yielding 5-6%. Notwithstanding the inflation impact, these figures are close to the LT expectations for the equity asset class but with less volatility, making fixed income a tougher competitor for equities in the minds of asset allocators.

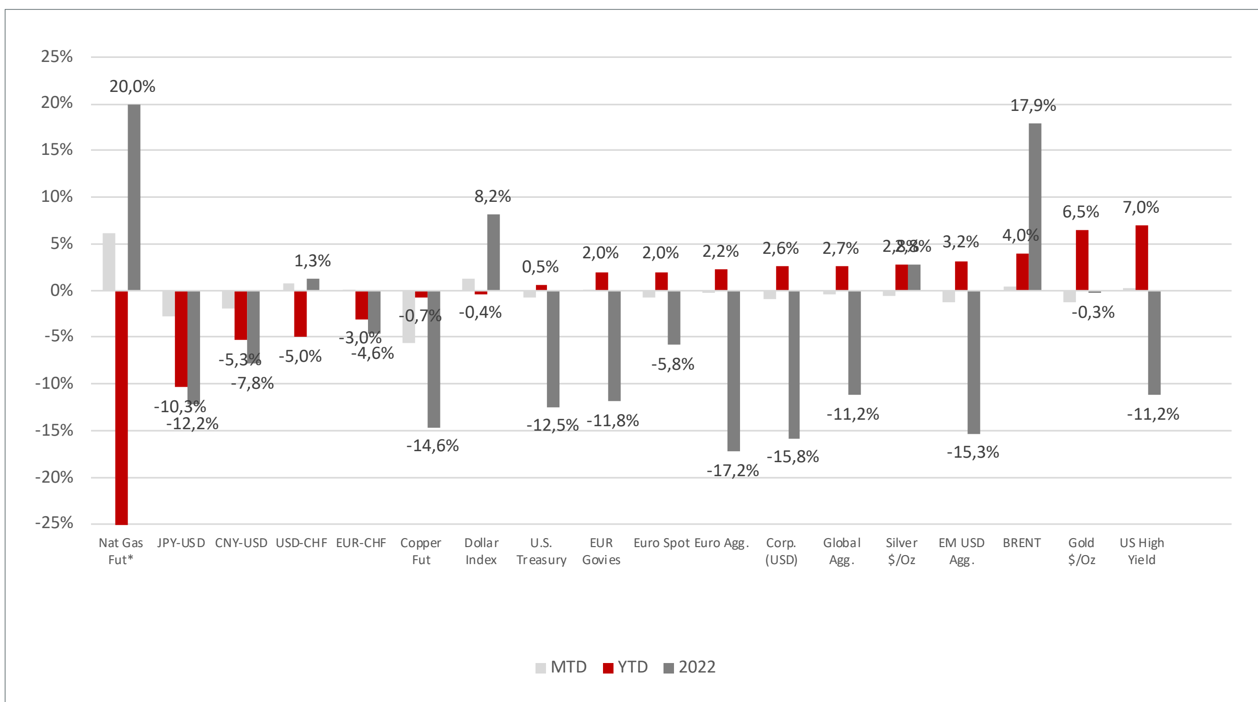
Against this backdrop, we maintain our selective bias towards equity markets, and continue to favor asymmetrical exposure through long-short strategies and structured products. Seasonality is less than favourable and could bring some volatility. We are at the starting-blocks to seize opportunities that may arise at any time.

5. PERFORMANCES

EQUITIES IN LOCAL CURRENCIES



FIXED INCOME, CURRENCIES AND COMMODITIES



Source : Bloomberg, Banque Eric Sturdza, 30/08/2023

** Natural Gas: -37.5% YTD*

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Contributors

Edouard Bouhyer, CAIA – CIO

Marc Craquelin, Senior Advisor

Eric Vanraes, Head of Fixed Income AM

Pascal Perrone, Senior Portfolio Manager

Jeremy Dutoit, Head of Advisory

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Contact

Banque Eric Sturdza SA

Edouard Bouhyer

invest@banque-es.ch

www.banque-es.ch