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1. EDITORIAL

HISTORY DOES NOT REPEAT ITSELF BUT IT RHYMES*

It is too early to draw full conclusions over 2022, but the adage takes on its full meaning as a number of events experienced this year are presenting some similarities with historical ones.

Cold War and Mao Zedong’s China making a come-back

On the political front, the Russian-Ukrainian conflict is not without reminding the Cold War situation, as the United States and Russia are fighting each other and are doing it through a proxy war. The parallel ends there. The ideological motivation appears more tenuous with Communism disappearing. The definition of opposing blocs is also quickly evolving: Central and Eastern European countries, former Moscow’s allies, changed side as they joined the European Union for the most part; neutral countries such as Finland and Switzerland are now leaning more towards the Western bloc. China’s role is also of concern: Once a vassal of the USSR, it now dominates Russia politically and economically and is key to resolve the conflict.

The 20th Congress of the Chinese Communist Party (CCP) ended up with a clear victory for Xi-Jinping. His power and control over the CCP were strengthened as evidenced by the reshuffle of the Standing Committee and the dominance of Xi-Jinping loyalists over reformists. On that note, the exclusion of Hu Jintao, the late president of China from the National Congress is enough to frighten the most daring investors... Never has a Chinese leader had so much control over China and so little counter-power since Mao Zedong.

Inflation, higher rates and strong dollar

The current economic situation looks also similar to the one experienced in the late 70s, after two oil shocks when faced with double digit inflation Paul Volcker, then Fed chairman had no other option to raise the Fed fund rate to almost 20%, plunging in the process the US economy into a severe recession. With Fed Funds at 3.0% – likely 3.75% in a few days - and core inflation at 6.6%, we are not there. With a higher public debt in 2022 compared to 1981 (125% Debt to GDP ratio vs. 31% in 1981), the pain threshold is assumedly lower and the embedded impact of the FED balance sheet reduction should not be underestimated.
Paul Volcker’s actions also partly explained the subsequent strengthening of the US dollar that peaked by mid 80s and led to the Plaza Agreement in 1985 by which the United States, Japan, France, Germany and the United Kingdom agreed to jointly intervene to weaken the US dollar. The intervention was so successful that the countries involved had to revert their interventions few years later… Once again, this situation is similar today, as the USD strongly appreciated against almost all currencies and has rarely been so overvalued. While such concerted interventions may have seemed very unlikely a few months ago, the likelihood has increased especially since a number of central banks (BoJ, BoE) appears to have already capitulated to prevent further weakening of their currency or to ensure financial stability.

In conclusion, we think it is important to stay true to our convictions without complacency and to refrain from succumbing to herd effects. YES, the USD had good reasons to be strong, but not all of them were obvious earlier in the year and the USD has rarely been so overvalued, making it prone to mean-reversion moves... YES, investing in China has never seem so difficult in light of increased political risk, but it’s equally important to note that Chinese authorities also need a robust economic growth to ensure social stability and that Chinese assets seem to already discount a lot of bad news. YES, the recession risk is high in Europe with potential energy rationing, but European stocks’ valuations are also partly reflecting this risk – and don’t forget that economic growth has been stronger this year on this side of the Atlantic. These are all elements that we develop in this newsletter.

*Mark Twain*
2. FIXED INCOME

3.50 + 6.60 = 0.75

Core inflation remains an issue

The US consumer price index (CPI) slowed very little this month, from 8.3% to 8.2%, but the core CPI (excluding food and energy) came out at a worrying 6.6% YoY, the highest level witnessed since September 1982. This figure lends credence to the thesis that more and more people share: if inflation is to come down from 8% to 2%, it will be a much longer process than the one imagined only a few months ago, since out of the 6% to be shaved, about half is coming from structural components. If we add to this the fact that the unemployment rate released at the beginning of the month stood at 3.5%, there is not much suspense left about the next FOMC meeting on November 2 and the upcoming rate decision: It will be 0.75% and the comments will shift to the probability of an additional 0.75% on December 14.

We could end up with a US policy rate at 4.75% in three months. If we add virtually 1% to this Fed funds rate to take into account the impact of Quantitative Tightening, which is too underestimated for our taste, we should enter the truly super-restrictive phase of the Fed’s monetary policy. With possibly a wrong timing? By trying to bring down inflation while pursuing a monetary policy that goes “too hard, too fast” to quote the words of Charles Evans, the chair of the Chicago Federal Reserve, the central bank in Washington is taking a big risk with the US economy, as much as with the world economy. Inflation fears are about to be supplanted by recession ones.

My name is Bond, Corporate Bond

The short end of the US Treasury curve was even more interesting this month. The 2-year rate at 4.5% and the 5-year at 4.25% really encourage you to start investing in Treasuries again. The first one as a “buy and hold” investor to park excess cash at higher yields and the second one as an active investor with a duration higher than 4.5, synonymous with capital gains when rates will fall once the recession arrives. Investing in US long rates above 4.5% was already a possibility if you dared investing in the too often neglected 20-year whose yield even exceeded 4.60% during the month.

Inflation fears are about to be supplanted by recession ones.

Above all, the current yield of US 2 to 5 year bonds allows us to consider investments in Investment Grade credits at gross yields close to 5% or even higher. This environment is also very favourable for dated products, which intend to “lock” a targeted yield and repay investors at maturity. We took advantage of this opportunity to launch a similar strategy with a 2025 maturity in dollars offering a very attractive yield.

Active management also has a bright future ahead of it and we must not make the mistake of pitting the two strategies against each other. There is no one style that is better than the other and the complementarity of the two will be for sure the winning solution.
In 1492 Christopher Columbus discovered what would later become the land of Freedom. As in most modern countries where democracy has taken hold, the United States has also gone through its darker hours... The word “freedom” takes on its full meaning politically and in a country where everything is deemed possible, the famous “American Dream” becomes a way of life.

On the other side of the Atlantic, Europe also experienced tough moments – autocratic regimes, revolutions, wars – the borders are no longer the same... In 1950, Robert Schuman, then French Minister of Foreign Affairs, proposed to pool coal and steel productions both in France and Germany, the beginnings of what would become the European Union. A few decades later, while the Western world is facing a major geopolitical crisis, the North Atlantic Treaty Organization (NATO) that gathers countries on both sides of the Atlantic reminds us how good the decision was, at the end of World War II, to unite the great democracies around the idea of a common defense. Sometimes contested, NATO got a new boost and the political differences on both sides of the Atlantic are erased allowing for balance and union that are needed to maintain peace and world order.

While political differences are fading, a gap is growing between the New World and the Old Continent in terms of valuation. The price earnings ratio gap between US and European equities remains well above its long-term average (see chart below). Indeed, European equities seem to have discounted a worse scenario, especially when taking a closer look at some companies that are more closely linked to the economic cycle, such as automobile manufacturers. Among European indices, there are a good number of so-called “value” stocks that are now trading at a deep discount compared to their intrinsic value. Surprisingly enough, this situation occurs as the broad European value indices (-13% YTD) are outperforming while more growth and technology biased indices dropped 30% YTD.

This greater resilience, the uncertainties related to business models of growth companies and the much more affordable valuation of the European market make it a rational choice. While the United States already entered into a “technical recession”, real estate is already showing signs of weakness and as the Federal Reserve is struggling to contain inflation, Europe may not look more appealing, but yet it stays more affordable. Admittedly inflation is also an issue there, but so far it remains primarily driven by commodities and looks more temporary on that angle. Surely, the Ukrainian-Russian conflict is affecting more Europe than the US and could deteriorate into a major energy crisis, but the ability of Europe to cope with it through a mix of reduced consumption, supply diversification, and increased storage should not be underestimated. Finally, even if the European markets rarely outperformed the US ones in recent history, the hurdles facing US companies are clearly higher – tighter financial conditions, wage inflation, a strong USD to name a few – Adding to that the possibility of a valuation normalization, it leads us to rethink this debate.
The question of the Fed Pivot is still very much alive and the long-awaited critical point seems to be approaching, while in Europe Christine Lagarde announced a new, widely expected, 75 basis point increase in the ECB’s key rate.

At the time of writing, the month performance of global equities (MSCI ACWI) is 5.2%, with European market outperforming the US one in local currency. The earnings season is well underway and continues to surprise positively. Broadly speaking, sales growth remains robust, margins seem less impacted as companies raised their prices to adjust to a new inflation paradigm. However, the results of the major tech and internet companies came in a bit disappointing, particularly in light of slowing digital advertising revenues and more muted guidance.

In Europe, quality growth is making a comeback as evidenced with the leading luxury companies reporting outstanding quarterly results, once again demonstrating their ability to adapt and diversify their end-markets, even if Chinese lockdowns are taking a toll on their activity in China, which often remains their biggest market. These publications also demonstrate the positive side-effects of a weak EUR for exporters.

We remain very selective and cautious in our investment choices decisions. We continue to focus on quality, especially in Europe and Switzerland, and to look for diversification through sectors, styles and geographies. Without modifying our underlying geographical allocation, we decided to change the geographical focus of our hedging overlay by placing more emphasis on our US exposure and less so on European equities. We also continue to favor less directional and more asymmetric approaches (Long short, structured products) to invest in equities.
5. PERFORMANCES

EQUITIES IN LOCAL CURRENCIES

Source: Bloomberg, Banque Eric Sturdza, 30/10/2022

FIXED INCOME, CURRENCIES AND COMMODITIES

Source: Bloomberg, Banque Eric Sturdza, 30/10/2022  
* Natural Gas +70.2% YTD.
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