BANQUE
ERIC STURDZA

MONTHLY NEWSLETTER
NOVEMBER 2023

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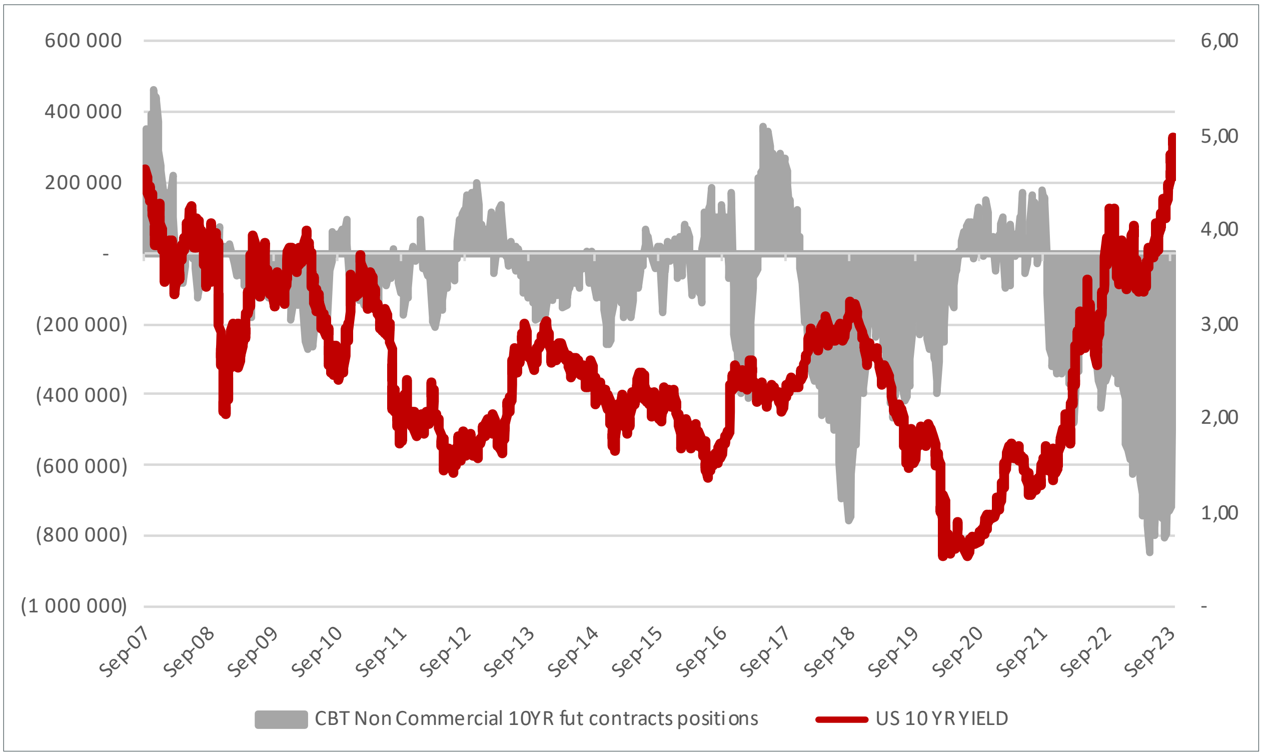
1. EDITORIAL

UNPRECEDENTED 3RD CONSECUTIVE YEAR OF NEGATIVE BOND RETURNS AND ‘DÉJÀ VU’ ON EQUITIES

After a compelling start to the year for financial markets, the last few months proved far more complicated. Long-term yields are on the rise again, with the US 10-year yield briefly touching 5.0% this month, a level not seen since 2007. In its wake, the phenomenon of rising long rates is spreading to other regions of the world, such as Europe.

After the 2022 *annus horribilis* for fixed income markets, investors thought that the post-Covid normalisation process was behind them. Clearly, it was far from over and the US 10-year yield, which was still offering 3.30% in March 2023, rose sharply. The first reason is inflation. Although inflation has strongly moderated since June 2022, it remains well above the Federal Reserve’s target. Too-hot inflation also reflects stronger-than-expected economic activity. It justifies a higher term premium. While the strength of the US consumer has much to do with it, public spending plays a major role and explains why the US public deficit is expected to balloon close to USD 2.0 trillion for this fiscal year. That’s quite a lot of new debt to issue for the Treasury department, and comes on top of existing maturities that must be rolled over. A new balance

G1 : US 10-YEAR YIELD VS. NON COMMERCIAL US 10-YR FUTURE CONTRACT POSITIONS



Source: Bloomberg, Banque Eric Sturdza has to be found, especially at a time when the Fed, China, Japan and Saudi-Arabia, all less price-sensitive buyers, are reducing or halting their purchases, making way for more price-sensitive others (such as banks, hedge funds, or institutions).

Rising long-term interest rates are having a significant impact on fixed income markets' performance, particularly that of US Treasuries, which are on track to post their third consecutive year of negative returns. This is unprecedented. While credit is faring a little better thanks to the carry offered by corporate bonds, the disappointment in terms of performance is on a par with the shock experienced by fixed income investors.

Despite this, it is probably too early to bury this asset class. First, the rise in short-term rates is probably coming to an end: as already signalled by the European Central Bank, and the Fed is probably not far behind. Second, with long-term yields close to 5.0%, the risk/return trade-off is once again attractive and likely to entice new investors. Third, speculative investors such as hedge funds have rarely been so short on long rates, and a reversal of these positions could exacerbate any drop in long-term rates. Finally, against a backdrop of renewed uncertainty in the Middle East, long government bonds could be useful havens sooner than later.

After an already less than stellar summer, equity markets continued to disappoint. Despite encouraging economic statistics, Chinese markets remain stuck in a property crisis and are struggling to stabilise. The Swiss market is in the red, a victim of its concentration and the underperformance of Roche and Nestlé. European markets fared little better, wiping out most of their early-year gains, as the return of certain value themes such as oil companies was not enough to compensate for losing momentum in growth stocks. Even the Nasdaq and S&P 500, which had previously looked untouchable, entered correction territory, falling more than 10% from their highs, and some of the seven stocks behind the index's gains ended by losing ground.

After a decade of TINA (There Is No Alternative), US equities are now enduring competition from fixed income markets. The deteriorating geopolitical situation in the Middle East, and subsequent uncertainties surrounding oil prices, are not conducive to risk-taking in the equity markets. And yet... the latest economic statistics from China and the US have positively surprised, testifying to the resilience of both economies and their consumers. Equally encouraging, the earnings season underway shows that after three consecutive quarters of decline, US corporate earnings growth is on track to post its first year-on-year increase. In addition, as a result of the market downturn, equity valuations now appear more reasonable, particularly outside the major US growth stocks.

In an uncertain geopolitical environment, with disappointing performances in both bond and equity markets, and the extreme polarisation of equity markets, we maintain a cautious stance and are building our portfolios around a few key ideas:

- **Maintaining a diversified allocation between risk assets (equities, credit) and haven assets (gold, the Swiss franc, yen) against a backdrop of geopolitical uncertainty.**
- **Appetite for bond markets as a carry strategy, and also increasingly for duration.**
- **A barbell" equity portfolio: complement US exposure with other geographic zones, and seek to balance growth stocks with more value-oriented sectors favoured by a higher interest-rate environment.**

2. FIXED INCOME

FIVE EVERYWHERE!

Cash is king... At least for now

Money-market and very short-term investments are currently favoured by investors. They wonder why they should venture into volatile markets with uncertain returns when the risk-free rate is an attractive 5.5%. This calculation pays off in the very short term, but proves a bad idea in the medium-to-long term, as markets offer far more attractive yields and performance prospects than a money market rate that is bound to fall again in a few months. Over the month of October, US long rates continued to rise, barely halted by a brief easing immediately after the return of geopolitical risk in the Middle East. The markets have now fully embraced the Fed's 'higher for longer' message, and long rates have readjusted. Today, the curve is 'disinverting' at full speed, and we will very soon find ourselves with a totally flat curve at 5%, excluding the money market. This kind of behaviour is typical of the entry into the final phase of a rate hike cycle. It is exacerbated by the circumstances just described.

Buy & hold

Buy-and-hold strategies, in the form of portfolios invested in direct lines or dated funds, are all the rage. Investors frustrated by more than a decade of near-zero interest rates finally have an opportunity to restore this type of management to its former glory, and rightly so. They should take full advantage of this opportunity, as current yields are extremely attractive. For example, an investment grade portfolio in dollars with a 2-year maturity offers an actuarial yield of 5.8%. However, a balanced bond strategy cannot stand on one leg. It makes no sense to bet absolutely everything on 'buy and hold,' despite its many advantages.

How to prepare for 2024 and beyond?

Real long-term rates at 2.5% are far more important to us than nominal rates breaking through the historic 5% barrier. This trend is set to continue on the long-term interest rate markets, and as long as there are no accidents, there is no reason for it to reverse. On the other hand, all it would take is for a problem to arise, and rates could start moving in the other direction again, in the form of a bullish steepening. Firstly, thanks to a flight to quality, but above all, the appearance of the slightest accident would immediately call into question the 'higher for longer' policy so dear to Fed Chair Jerome Powell. At the same time, expectations of rate cuts by the major central banks would reappear as if by magic. There are still two months to go before the 2023 vintage comes to a close, but in all likelihood, US Treasuries indices will finish in negative territory for the third year running. This is unprecedented, so, don't be in a rush to bury this asset class too quickly, or you'll be in for a rough ride over the next two or three years.

The markets have now fully embraced the Fed's 'higher for longer' message, and long rates have readjusted.

3. EQUITIES
WHEN THE TIDE GOES OUT…

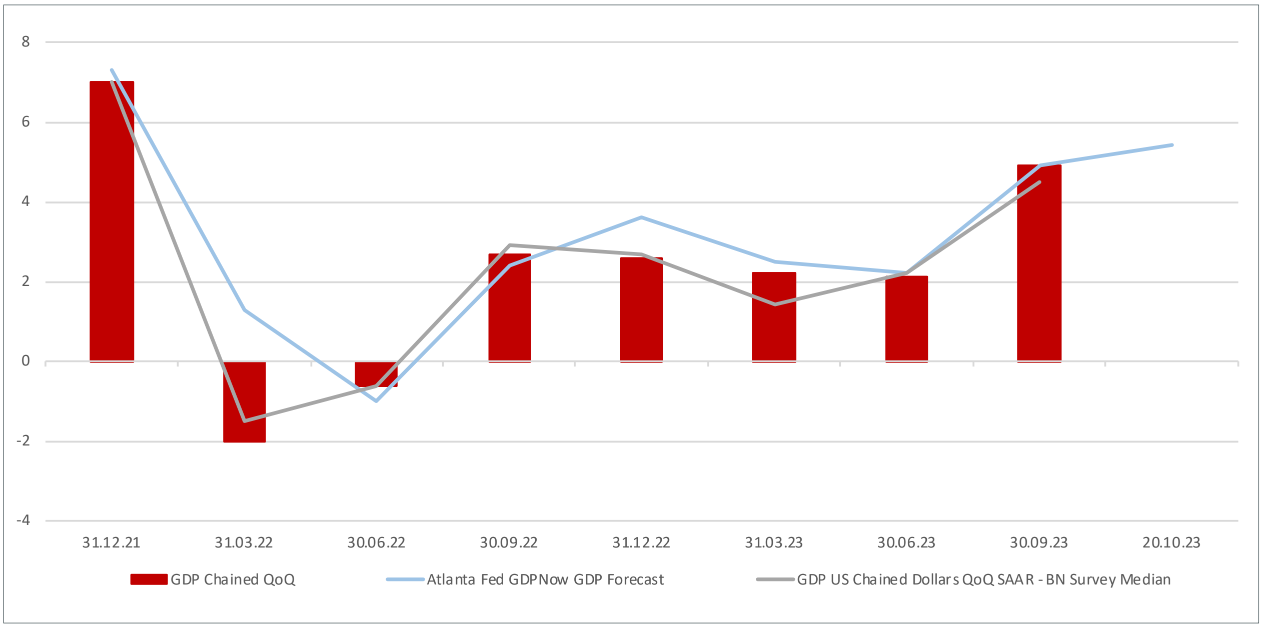
The month of October confirms the trend begun in mid-summer, with market participants' anxiety sending the S&P 500 to test support around 4,200 points, 9% lower than the top reached at the end of July.

The third-quarter earnings season is already well underway. 60% of S&P 500 companies have released their balance sheets, and the surprises at this stage are rather positive, particularly in terms of earnings. Growth is more sustained (+2.9%), particularly in the communications (+36%) and consumer discretionary (58% thanks to awesome Amazon results) sectors. It also marks the return of EPS (earnings per share) growth after a decline over the last three quarters.

In Europe, the picture for the moment is very different. First, European companies are not subject to the same quarterly reporting obligations as their American counterparts. Even if earnings surprise slightly upwards, sales of companies that do report are down by almost 5%. This figure is heavily impacted by the decline in profits in the materials and energy sectors (-36%). Given that these are the same sectors that were underpinning growth a year earlier, this is more a case of normalisation than anything else.

The tension is palpable, and at a time when interest rates are hitting record highs (the US 10-year yield is just below 5%, very close to S&P 500 corporate earnings yield levels), there's no room to hide, and the pull for allocators is strong. Volatility is rebounding, although it remains contained at around 20% in Europe and the US. Another sign of tension is that companies which publish results below expectations and/or revise their guidance, are seeing their share prices punished, with rarely-seen declines of over -20% in a single trading session.

G 2: US GDP VS. ESTIMATES



Source: Bloomberg, Banque Eric Sturdza

Even if it is too early to draw conclusions, we continue to see significant US resilience, as shown by the latest revision of annual growth at +4.9% (see chart).

Models predicting 12-month recessions are revised, and the probability falls from 70% to 56% in the space of a few weeks. Year-on-year inflation stabilised at 3.7% at the end of September, and core inflation continued to fall towards 4%.

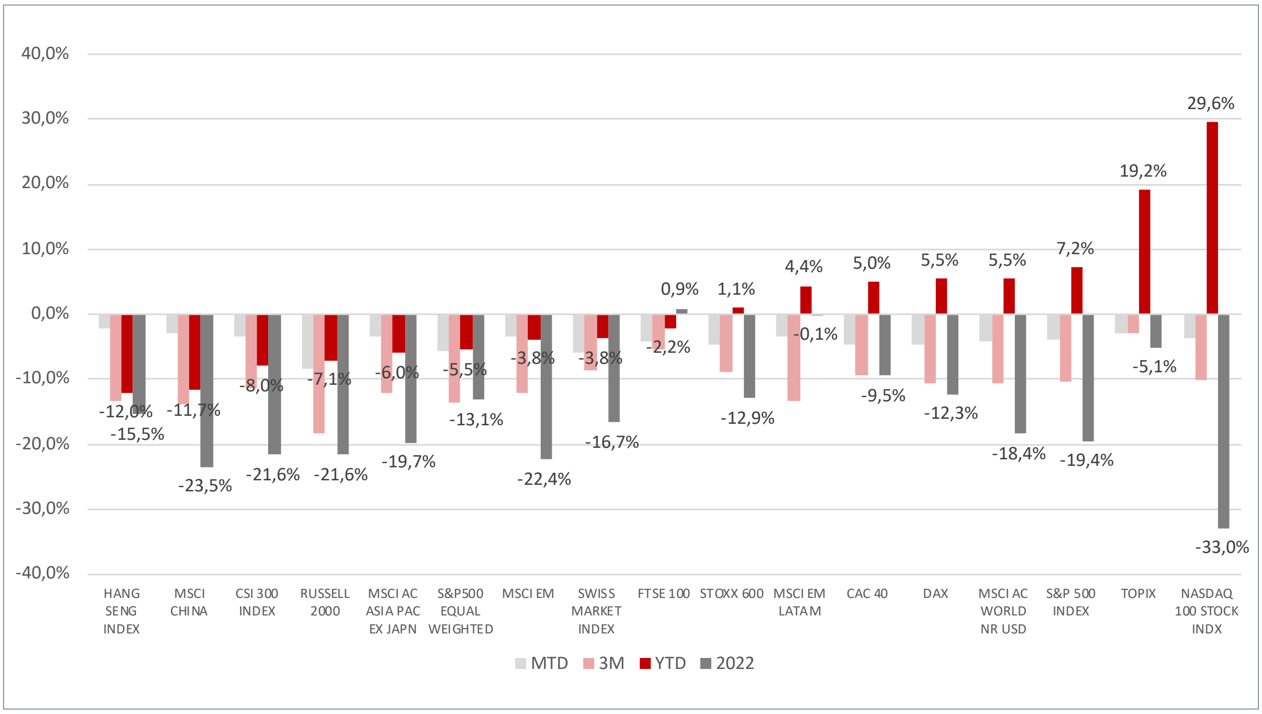
European yields are also at high levels (German 10-year sovereign Bunds are just below 3%). Purchasing managers' indices (PMI) continue to dip below 50, synonymous with economic contraction, and retail sales are in negative territory, but economic surprises after a very long period in negative territory seem to be reversing.

The global geopolitical situation is heightening uncertainties, particularly in the Middle East, where a wider conflict would have a major impact on international relations, leading to renewed interest in certain assets, notably oil and gold.

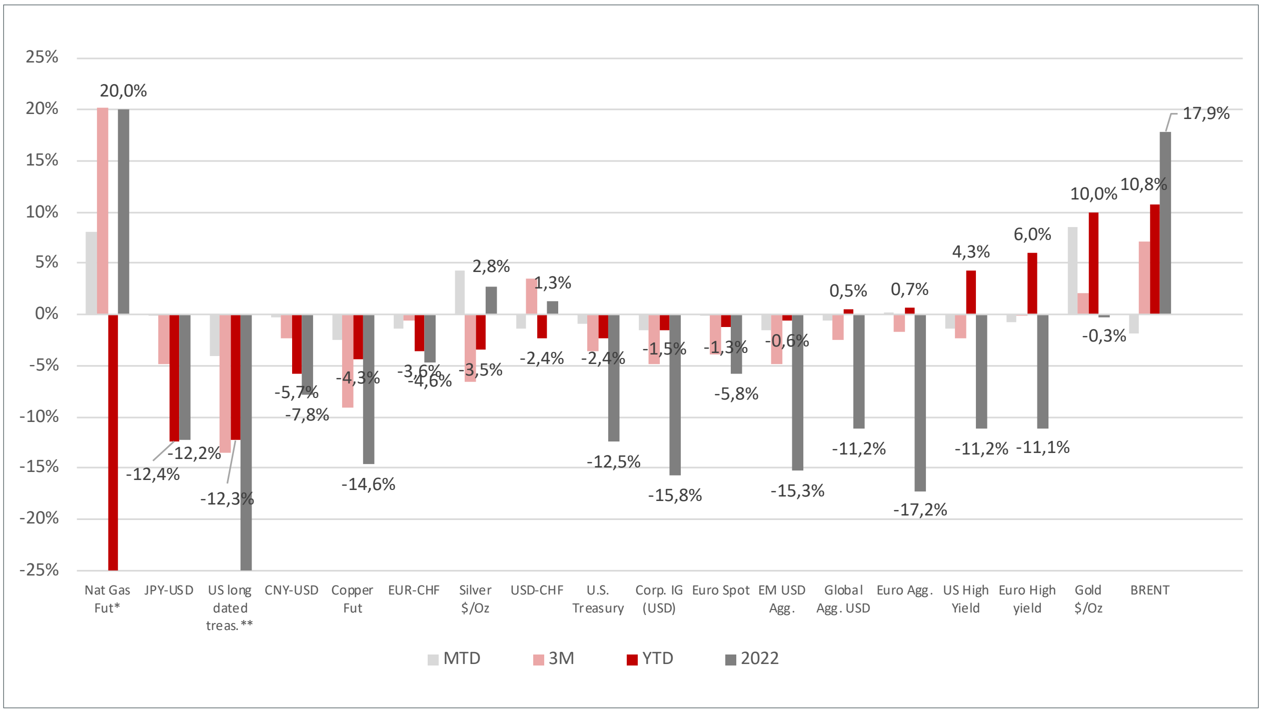
In this environment, we are making the most of current market conditions (volatility, elevated risk free rate) through structured notes to optimise the risk/return profile of our investments and build customised, asymmetric pay-offs, that offer upside participation in equity indices while providing capital protection.

5. PERFORMANCES

EQUITIES IN LOCAL CURRENCIES



FIXED INCOME, CURRENCIES AND COMMODITIES



Source : Bloomberg, Banque Eric Sturdza, 28/10/2023

** -29.3% YTD ** -29.3% 2022*

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