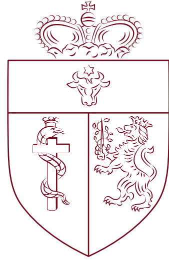

BANQUE
ERIC STURDZA

QUARTERLY OUTLOOK

3RD QUARTER 2023

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1. EDITORIAL

THE WINNER TAKES IT ALL...

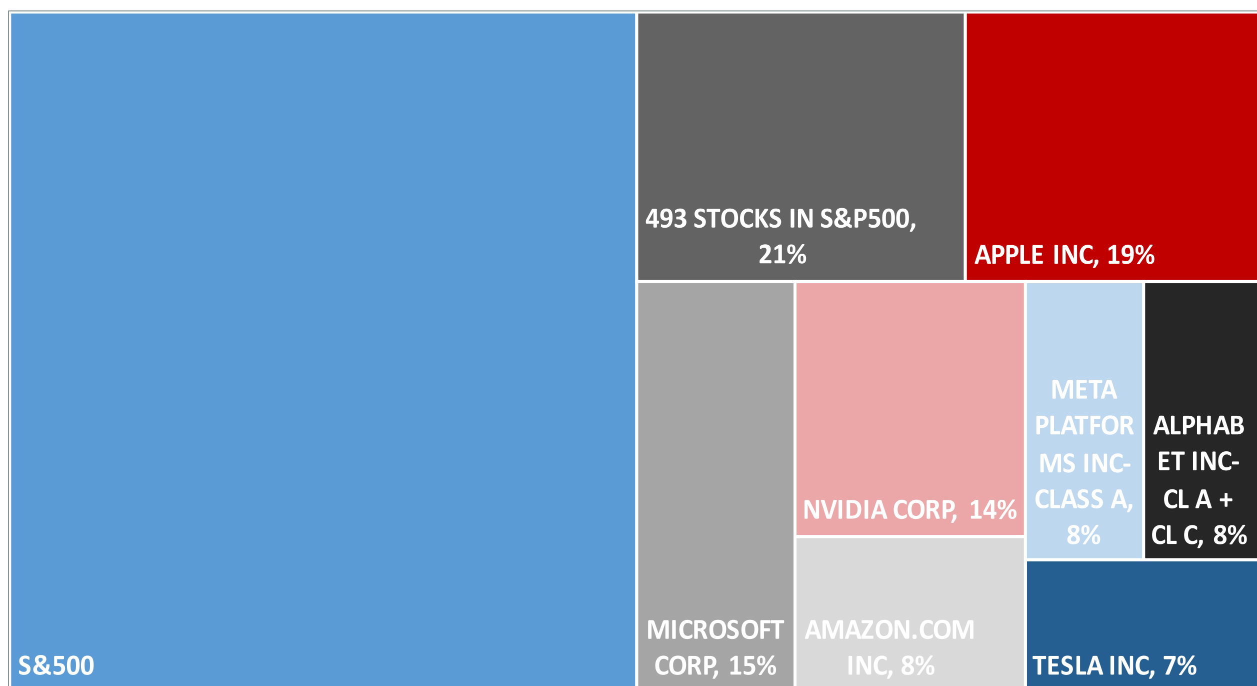
The first quarter of 2023 was marked by the banking sector's crisis, specifically the woes of medium-sized banks in the US and the collapse of Credit Suisse on this side of the Atlantic. The determination of central banks and lightning bailouts enabled us to move on quickly allowing the second quarter to highlight three winners: the US central bank, the US technology sector and the Japanese market.

At the risk of claiming victory a little early, it seems that the inflation trajectory is showing encouraging signs. Admittedly, the fall in commodity prices has played a big part in this, but headline inflation in the US has fallen from 6.5% at the end of 2022 to just under 4.0% in June 2023.

Jerome Powell remains cautious and, as he reminded us, the central bank simply "skipped its turn" by not raising rates on 14 June. Nevertheless, the eagerly-awaited rate peak by investors is within sight and only a matter of a few weeks, taking the benchmark to a level of around 5.6%. The battle against inflation is therefore on the way to being won, and markets are already thinking about the next move.

The technology sector had already made good progress at the start of the year, and the second quarter saw an acceleration thanks an Artificial Intelligence frenzy. By now, every reader of the financial press is familiar with Nvidia, with its nearly 200% year-on-year growth and USD 1,000 billion market capitalisation. It's true that it's not often that a company 'surfs' successively on the back of three

GRAPH 1 : VISUALIZATION OF S&P500 YTD PERFORMANCE THROUGH ITS MAIN CONTRIBUTORS



Source : S&P DJ Indices, Howard Silverblatt, YTD

enormous growth pedals, but this is exactly what has happened: it is a must-have for the video game industry, a must-have in the crypto-money mining business and now a big winner in artificial intelligence.

Less spectacular, the advances made by other technology megacaps are nevertheless impressive (Facebook/Meta 128%, Apple 47% Microsoft 39%...).

Identifying a buoyant theme is one thing, finding the long-term winners is quite another. While Microsoft is still one of the world's largest market cap, the stars of Intel and Cisco have faded.

With rapid gains and a performance concentration within a very small number of stocks, are we in the process of repeating a scenario similar to that of 2000?

The sector is undeniably expensive. The Nasdaq is trading on a 32 times multiple based on 2023 earnings, while the FAAMGs are at a multiple of 37.5 times. However, this is a far cry from the megacap multiples of 2000. At their peak, the MICOs (Microsoft, Intel, Cisco, Oracle) paid nearly 90 times earnings (according to Les Cahiers Verts)! That said, the comparison offers a different perspective: identifying a buoyant theme is one thing, finding the long-term winners is quite another. While Microsoft is still one of the world's largest market capitalisations, the stars of Intel and Cisco have faded.

All in all, the tech craze may be a little excessive, but it's far from presenting the same risks as in the late 90s, provided they can deliver on their growth promises.

Then there's Japan. The Nikkei is up 29% and the Topix by 23%: Japanese equities have risen with great regularity in recent weeks. A number of reasons have been put forward: a weak currency is helping exporters, a possible end to the deflation that plagued the economy and investors – fed up with the weakness of Chinese markets – are turning to Japan, accompanied by those following in the footsteps of Warren Buffett (recently a big buyer of Japanese stocks). There are also more fundamental reasons for this. It seems that business leaders want to see shareholders better rewarded, as evidenced by the sharp acceleration in share buy-backs.

There are only three steps on a winners' podium, yet we should also have mentioned the credit markets, which are making headway. High yield, in particular, has made good progress in recent months (around 5% since the start of the year in Europe). We had been increasing our portfolios' exposure to Investment Grade credit since notably for USD based portfolios last summer, but bonds as a whole still seem interesting to us, and after this major stock market rally they offer an even more attractive risk/return profile. The Fed's timetable, now clearer and better integrated by the markets, will enable us to gradually lengthen duration. There is time to let the markets settle into Andrew Mellon's motto: gentlemen prefer bonds!

2. MACRO FOCUS

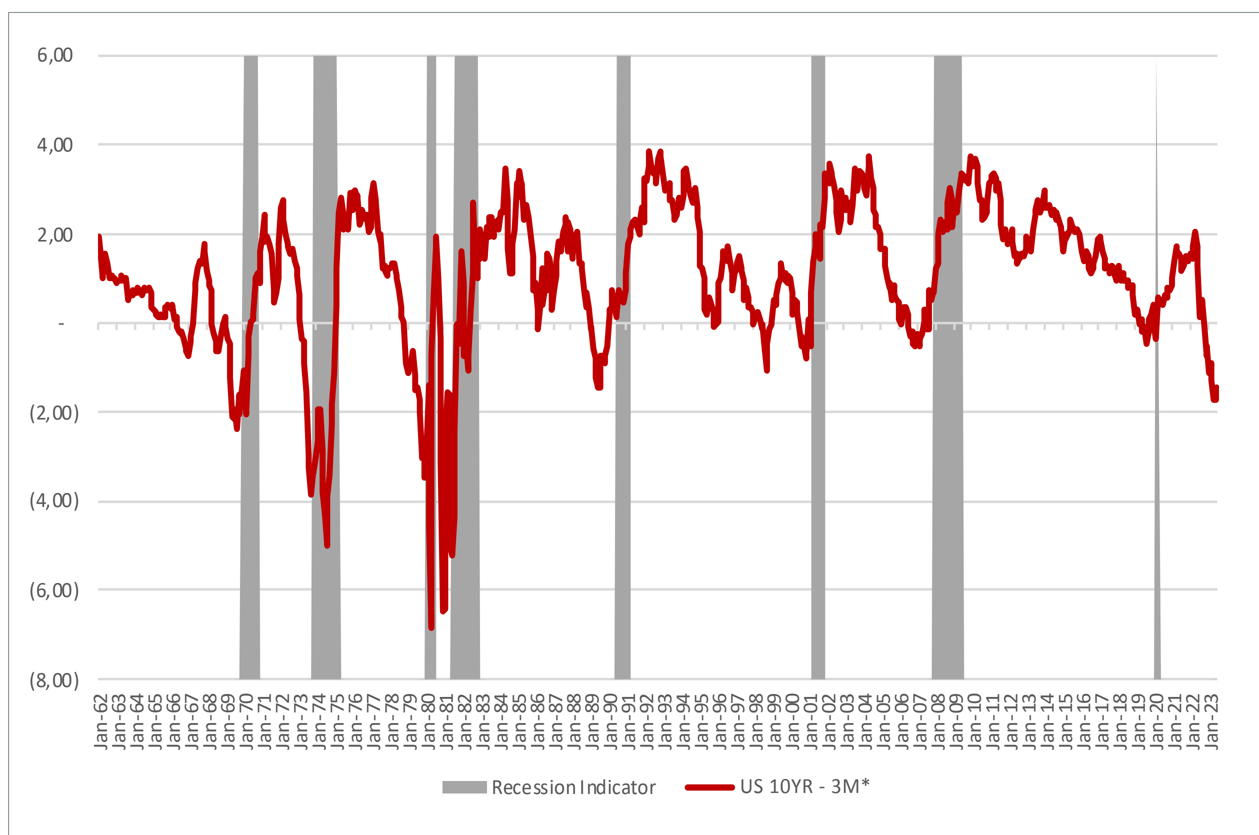
CHRONICLE OF A RECESSION FORETOLD

In Gabriel Garcia Marquez's novel *Chronicle of a Death Foretold*, the narrator sets the tone from the start by telling the story of his friend's murder that all but him are expecting. The parallel with the economic world is troubling, as rarely has a recession been so widely anticipated.

Although feared last year following the Russian-Ukrainian conflict and the Fed's massive rate hike, the recession has not yet begun – at least not officially. US growth has slowed under the impact of the Fed's restrictive policy, but for the time being it has proved relatively robust, helped by the resilience of services and the strength of the American consumer. And yet, yield curve has been inverted for months and this indicator is supposed to be one of the most reliable ones, and certainly one of the most closely watched, as it is included in various predictive recession models.

In addition to possible false signals, two other factors are important to consider. 1. Yield curve inversion is generally not concomitant with recession, and 2. its amplitude has relatively little predictive power on the extent and duration of a recession. As evidenced when analyzing the US 10yr – 3m yield curve and the recession occurence (see graph 2), the widely 'anticipated' recession is not yet overdue.

GRAPH 2: US 10-YEAR MINUS 3-MONTH YIELD CURVE (RED) AND RECESSION INDICATOR (GRAY)



Source: Bloomberg, NBER, FED, BES - 01/1962 to 06/2023

**FED fund rate prior to 99 instead of US 3M T-bills*

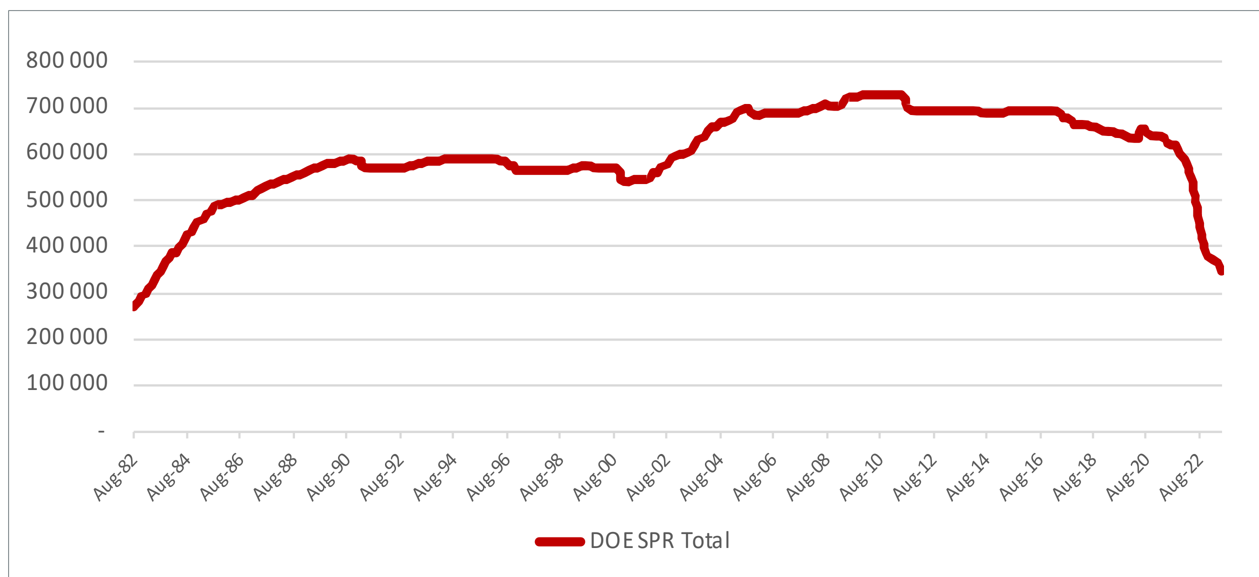
Several factors are likely to explain this lag in the economic cycle and one to keep in mind is the increasing importance of Asia and its contribution in world economic growth. In 2023, Asian is expected to contribute more than two-thirds of global economic growth (source: IMF, World Economic Outlook), with China and India leading the pack (34.9% and 15.4% contributions respectively). Therefore, Asia and especially China, remain the key growth driver in the months ahead and their role should not be down-played.

Excessive optimism about China's reopening has turned to pessimism and the latest macro figures may have disappointed on the manufacturing and export fronts – much less so on the consumption front. However, they do lend credence to the idea that China's authorities will provide more monetary and fiscal stimulus. The move has already begun this month with the lowering of some key interest rates, and should continue as the central bank is not bothered by inflation.

Even if a lot has been said about it, inflation is the other main explanatory factor and likely to remain at the heart of macroeconomic concerns, whether in Japan, which sees this as a historic opportunity to put behind the deflation that plagued its economy for three decades, or in western economies, which are trying to cool down inflation at any price. In the US, it is true that disinflation is well under way, with headline CPI falling to just under 4.0% (from 9.0% last year), under the effect of falling energy commodity prices and favourable comparables. Even so, the core figure (excluding energy and food) remains high (5.3% YoY) and constitutes a major constraint for the Fed. This is all the more true given that energy base effects are becoming less favourable as the summer draws to a close, that US strategic oil reserves – which will eventually have to be replenished – are at an all-time low (G3) and that, as the insurrection by the Wagner troops underlined in Russia, geopolitical risk cannot be completely ruled out.

A soft landing scenario for the time being in the United States, a mild technical recession in Germany, the end of deflation in Japan and a recovery in China - there are many scenarios to juggle and they justify maintaining a balanced overall scenario with two strong macro convictions - diversification and the Asia bias - even if the latter has not yet paid off.

GRAPH 3: US STRATEGIC OIL RESERVES IN THOUSANDS BARRELS



Source: DoE, BES, 1982-2023

3. FIXED INCOME

RECESSION ? WHAT RECESSION?

2-10 years at -100bp

The recession is playing out a remake of *Waiting for Godot*. Has Jerome Powell become the Samuel Beckett of the markets? In the world of bond management, a technical recession has been underway since early July 2022, when the 2-year/10-year US Treasury spread moved into negative territory. The onset of the real economic recession, generally six to twelve months after the start of the technical recession (inversion of the yield curve), is likely in the current circumstances to occur after a longer period of time, of around eighteen to twenty-four months. The onset of an economic recession must be taken very seriously, as it will go hand-in-hand with a steepening of the yield curve following a violent collapse in the 2-5 year part of the curve as a result of expectations of a sharp cut in key central bank rates.

Today, we have passed the -100 basis point level of inversion in 2-10 year US yields, which is quite simply historic! Before the move into negative territory a year ago, the record level of the 2000s stood at -51 bps in April 2000. This move beyond -100 bp is not unique this year, since we reached -108 bp on 8 March. The spread then quickly fell back into the -50 bp territory following the debacles of the US regional banks, raising the prospect of possible rate cuts by the Fed and triggering a rally in the 2-year note. This rally fizzled out as calm returned to the US regional banking sector.

Long term rates greet you!

Long yields continued their advance and the 10-year broke the 3.70% level on the way down. What a long way from 4.09% on 2 March! A 40 bp easing, with a duration of 8.3 years. Recent events in Russia could have further destabilised the curve. Everything seems to have returned to normal in Moscow, but such 'black swans' remind us that US long yields are also a hedge against bad news wherever it comes from (economic, political, financial markets, terrorism, natural disasters, etc.).

At the start of the summer, we maintain an investment policy that reflects our current level of prudence, i.e. less credit risk and a longer duration than usual in our main investment vehicle. Credit is becoming expensive, high yield is unaffordable, emerging markets are not paying the risk premium associated with their status and hybrids are a little less attractive. If we were to change this cautious policy in the second half of the year, we would be tempted by some high-quality emerging credits. **We will no doubt be returning to this asset class in the near future, but some of them will have to make an effort in terms of their ESG rating, otherwise they will disappear from our investment universe.**

4. EQUITIES

A GENTLE SUMMER IN A WORLD ON THE MOVE

‘Sell in May and go away’ is an adage that has often been called into question, but this year, at least over the first fortnight, it has been confirmed. The downturn, or consolidation as some would call it, was short-lived, however, as the month of June took equities to their annual highs. The very high concentration of indices’ performances in a limited number of stocks described in our previous publications is still the case.

The MSCI World now has an annual performance to date (27.06.2023) of 11.20%, the S&P500 has gained 12.7%, the Nasdaq 100 risen 34.3%, the MSCI Europe is +6.8% and MSCI China, which is struggling to get going again, is at -6.5%, despite the economic support plans promulgated by the People’s Bank of China.

The two major announcements in June were the avoidance of the US default, with the agreement reached on the public debt ceiling, and the last FOMC in which Mr Powell, decided with his committee to leave rates unchanged and even prepared the market for possible further hikes. The volatility of interest rates was felt at a time when most market participants were eyeing rate cuts as early as 2023.

Equity markets, for their part, still seem immune and fail to react to macroeconomic or geopolitical events. In fact, there has been neither tremor nor stress, with a few major announcements from companies such as JD.com, which is following the example of its big brother Alibaba and wants to split its group into several separate companies. Meanwhile Apple seems determined to plunge us into a highly accomplished virtual reality thanks to its Apple Vision Pro, and Nvidia has now joined the very select group of companies worth more than a trillion dollars.

However, the start of the summer season was marked by Wagner, the Russian mercenary group, which seemed intent on overthrowing Russia’s Ministry of Defence and walking on Moscow before doing an about-face a few hours later and moving to Belarus.

The US, for its part, has decided to establish diplomatic, economic and even military relations with India, which is seen as one of the world’s new growth poles for the coming decades, at the very time when Sino-American relations are at a low ebb.

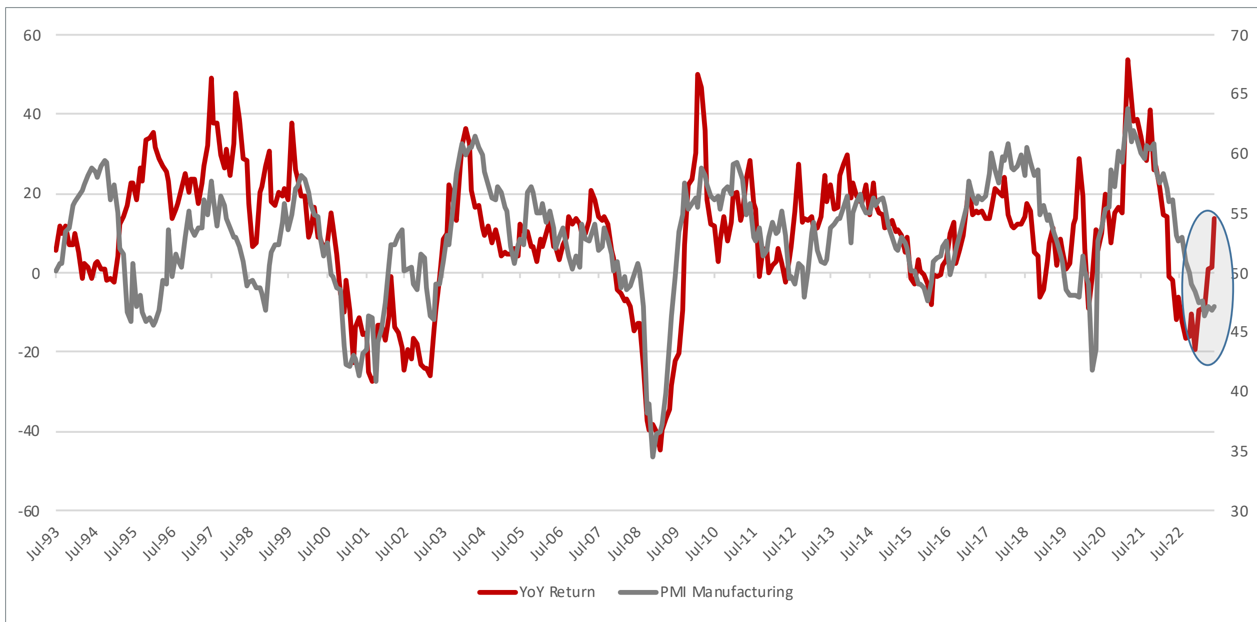
Is an economic recession possible?

The US yield curve is inverted, and this closely watched indicator is screaming recession for several months. In reality, and despite expectations of weak growth, the resilience of our economic systems, particularly in the US, continues to surprise. The labour market remains robust, while behind the scenes we are seeing a marked loss of momentum in certain sectors, notably commercial property.

The reason for such a gap may be found in robust non manufacturing activities. Services in the US are slowing across the board but from a high base, with the ISM indicator published at the beginning of June (for May) showing a fall in new orders received by companies. This has led to a slowdown in prices in the sector, which is also good news for the Fed.

On the contrary, the latest figures indicating the direction of industrial activity in the US (Manufacturing ISM) have fallen a little further below 50, i.e. into contraction, another possible recession indicator. The clothing industry was particularly hard hit in May, due to a sharp rise in costs and weak demand in the sector. **Over the long term, we have observed a strong correlation between the S&P500's annual performance and the US Manufacturing ISM (see G5). In recent weeks, however, there has been a significant divergence between the two in favour of the S&P500. A good reason to remain cautious for the time being.**

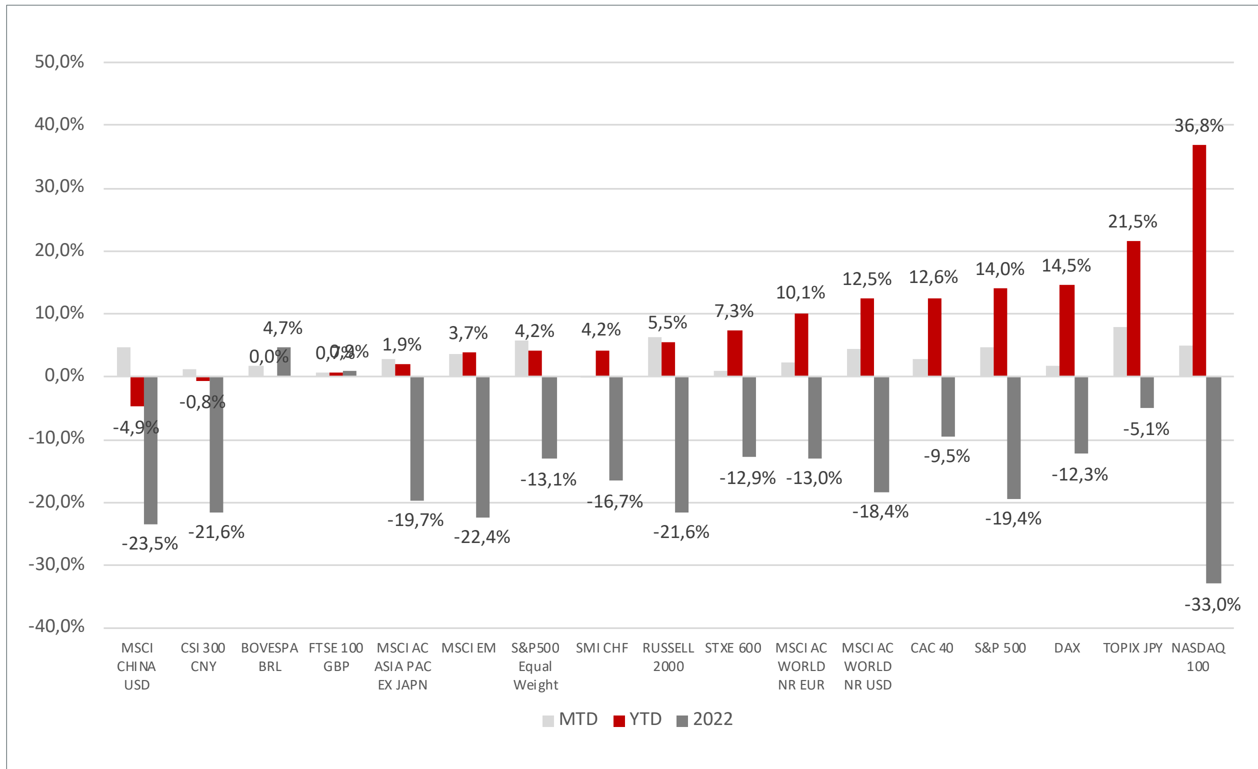
GRAPH 4: S&P500 YOY CHANGE VS US ISM



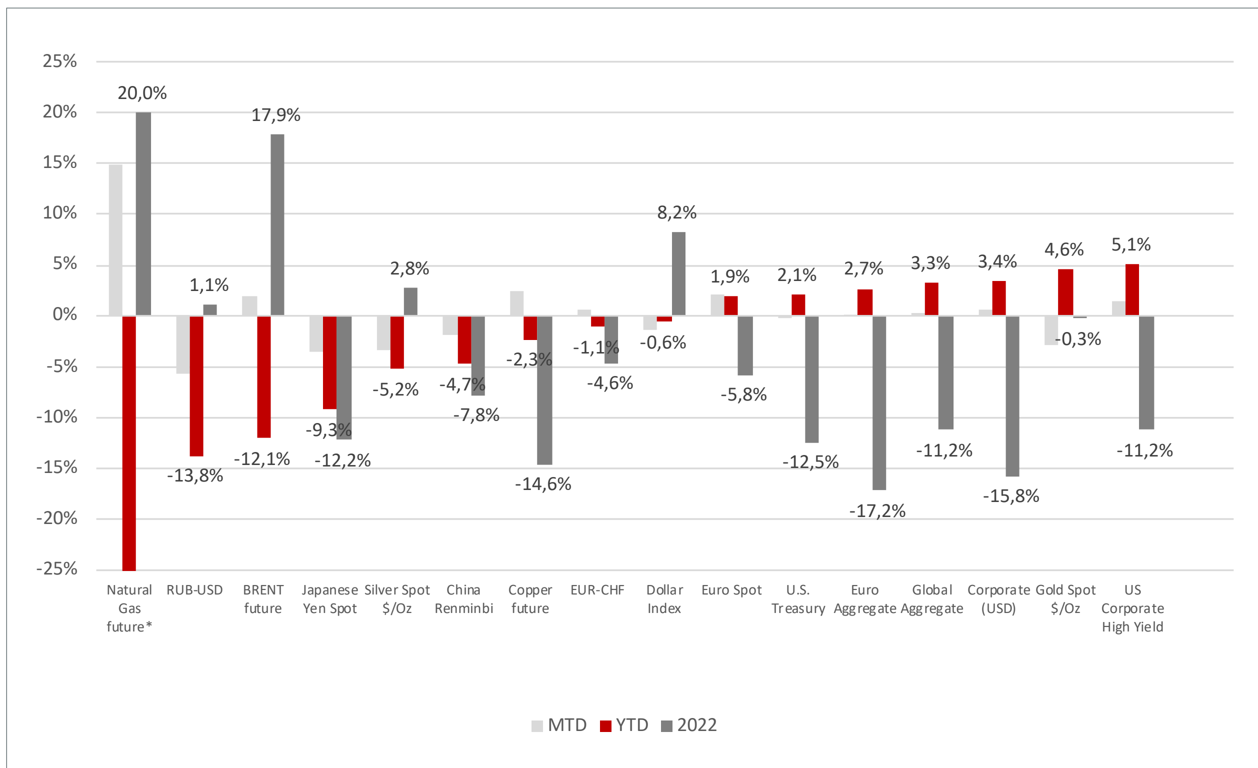
Source: Bloomberg, ISM Manufacturing, BES, 93 -23

6. PERFORMANCES

EQUITIES IN LOCAL CURRENCIES



FIXED INCOME, CURRENCIES AND COMMODITIES



Source : Bloomberg, Banque Eric Sturdza, 29/06/2023

** Natural Gas: -42% YTD, -14.9% MTD*

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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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