BANQUE
ERIC STURDZA

QUARTERLY OUTLOOK
2ND QUARTER 2022

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1. EDITORIAL
DURING WAR TIME.

There is a sense of unease to start a financial editorial when an event as dramatic as the war in Ukraine is ongoing. Thousands of deaths, hundreds of thousands of Ukrainians displaced... One month after the beginning of the war, the situation is terrible and to wonder about the impact of this conflict on the stock markets may seem cynical.

We will nevertheless remain on financial ground. At the risk of adding to the cynicism mentioned above, we will start with what has not changed in the markets. First, the inflation outlook and the policies to be expected from the FED and the ECB. At the end of 2021 we were talking about an imminent regime change, now we are there. Prices are galloping (the conflict-induced rise in oil and gas only adds to an inflationary trajectory already underway) and central bankers have no choice. The 25 bps rate hike in the US on March 16th is only the first of many, with six more likely to follow in 2022, and the period of hesitation during which markets doubted the response of central bankers will only have lasted a few days. The «flight to quality» that pushes investors to buy government bonds will have been a short-lived flight, as the 10-year rate on US Government bonds will have eased for only a few hours. At 2.51%, it is now higher than before the start of the conflict ... Two possible interpretations, the first - anxiety-inducing - means that inflation is so worrying to the central bank that it supplants any other parameter. The second - more reassuring - is summarized in a recent statement by Jerome Powell who sees the risk of recession «not particularly high» and a «particularly solid» US economy.
Both readings are probably worth keeping in mind: growth maintained in the US but against a background of marked price increases.

The situation is different in Europe. The proximity to the conflict, the stronger dependence on Russian commodities (the United States is almost self-sufficient in Energy!) lead to a heavier economic impact on this side of the Atlantic.

Growth maintained in the US but against a backdrop of marked price increases.

Different numbers are circulating: the ECB "sees" the impact of the conflict at 0.6% on European GDP, while the OECD estimates it at 1.4%. The exercise is difficult and depends on uncontrollable parameters, in particular the duration of the conflict. It is therefore necessary to look at the big picture and choose a scenario. Unless there is a further deterioration, the declines in GDP mentioned above should not plunge Europe into recession (such a scenario would surely lead to a "peak to trough" decline of around 40% for European equities and the markets would still be "too expensive"). If we instead assume a mid-range scenario with a GDP revision slightly above 1%, we would have an impact on earnings of around 10 to 15 bps. The current market level is probably a reflection of this assumption.

Without necessarily modifying asset allocation weights, we need to adapt to this environment, which is different from that of previous years. Keep in mind the upward pressure on interest rates mentioned above, as it will continue to weigh on the most expensive stocks, thus prepare for more frequent style changes as long as the growth outlook is not more established, focus on stocks that are best able to pass on price increases, find reasonably valued players in the energy transition... There is no shortage of avenues to explore, but after years of established trends, we are surely entering a period where agility will become the key word.

2. MACRO FOCUS

A HISTORICAL RUPTURE.

Beyond the disastrous human consequences of the conflict, which we can only deplore, it is the economic consequences that we focus on in this section.

Less growth, more inflation

The year 2022 should see growth decelerating after the post-Covid rebound. The deceleration would be more pronounced, particularly in the Euro zone, because of its geographic proximity to Ukraine, its dependence on Russian energy and other raw materials. Between the ECB's initial estimates of a 0.6% impact on European growth and those of the OECD, which anticipate a 1.4% impact, the gap is wide and remains difficult to quantify, as it will depend on the length of the conflict, further deterioration and the associated ripple effects. The post-Covid growth regime expected prior to the conflict - 4.2% –, as well as the floor provided by fiscal stimuli, should be enough to keep the recession spectre at bay, at least for the time being, but the risk is increasing.

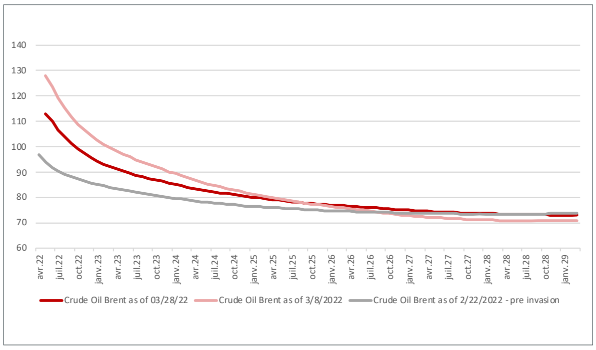
The conflict should also act as a booster on the inflation front. Unlike in the US, price increases in the Eurozone at this stage are more a result of rising prices for goods and services than of a price/wage loop. At 5.9% year-on-year, the rise in consumer prices may seem high, but it falls to a more acceptable 2.7% excluding energy and agricultural products, implying limited wage pressures... Unfortunately, the evolution of commodity prices suggests little improvement on this front, with the OECD even anticipating a 2.0% increase in inflation in the Euro zone mostly related to this factor. It is indeed the stagflation scenario that seems the most threatening.

The conflict should also act as a booster on the inflation front

A commodity shock

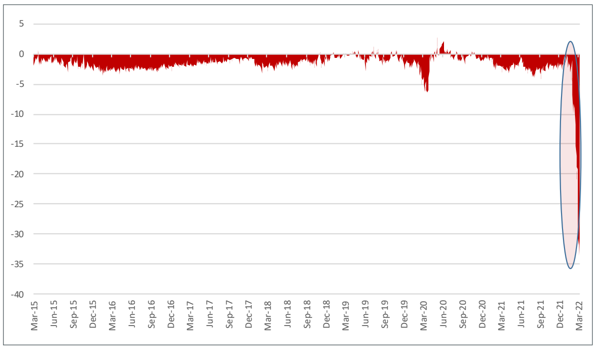
The most visible consequences of the Russian invasion of Ukraine are the sharp price increases in a wide range of commodities. Energy is the first to be affected. The simple fear of seeing Russian energy exports to the EU reduced or eliminated was enough to propel gas and oil prices during the month ($128/barrel for Brent, £579/Therm for gas). After the initial shock, these levels normalized somewhat - $107.9/bbl and £283.2/Therm -, the alert is nevertheless real and suggests a recessionary scenario in the event of a slippage of oil price above $150 for a sustained period. The upward price move of oil contracts for immediate delivery should not make us forget the complex reality of oil markets: Prices fall sharply as soon as we move away from contracts with a near-term maturity (see graph 1). This situation can be explained either by the anticipation of an end to the crisis and a rapid normalization, or by the maintenance of prices high enough in the short term to trigger a recession and the associated demand destruction. Similarly, talking about high oil price, everyone thinks of the international reference, Brent, but is forgetting a little quickly that Russian oil, which few people want to touch, is trading at historical discounts (see graph 2). The geopolitics is being redrawn between Europe that is accelerating its energy transition to reduce its dependence and Asian consumers (China, India) that are securing supply at discounted prices. More worryingly, let's not forget that Ukraine and Russia are big grains exporters and that the conflict has already pushed wheat prices higher. To illustrate how dramatic the situation is, it is important to remind our readers that the Arab Spring was triggered initially by a food crisis, an important reminder and a good reason to stay selective on Emerging assets for the time being.

CHART 1: BRENT – FUTURES CURVE AS OF 28/3, 08/3 AND 22/2



Source: Bloomberg, Banque Eric Sturdza

CHART 2: RUSSIAN URAL OIL DISCOUNT VS. BRENT



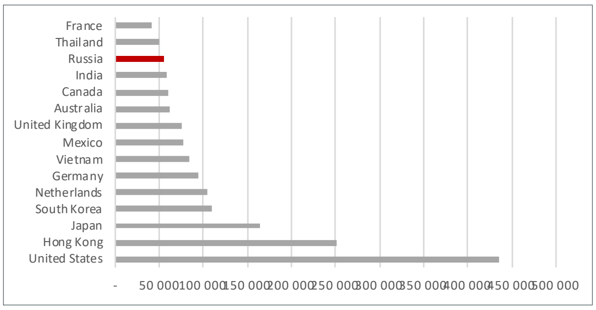
Source: Bloomberg, Banque Eric Sturdza

China, the hardest hit economically

Surprisingly enough, one month after the beginning of the conflict, finally it is the Chinese markets, outside of Russia, that are the hardest hit... We can pinpoint several factors to explain this. On the health front, a spreading Omicron variant is seriously questioning the validity of the zero-Covid strategy, as several Chinese cities are facing new lockdowns. China is also making lots of efforts to rein in their real estate crisis and its side effects. Finally, China's ambiguous position is not unrelated to this counter-performance, divided as it is between its pledge to support Russia and the fear of seeing its economy paralyzed by similar economic sanctions... In this context, it seems difficult to imagine the Chinese authorities ready put at risk the implicit social contract binding the Communist Party with the Chinese population - economic prosperity in exchange for political stability. The regulatory wave that hit technology stocks last year shows that the Chinese government's motives can go beyond short-term calculations... The support provided through bold statements to support the economy and Chinese stock markets, the decision to put the property tax reform on hold and the accommodative stance of the PBoC – a sharp contrast with the FED - nevertheless suggest that the context might be different this year and give hope for stabilization. In the meantime, depressed valuations and Chinese equity markets in bear market suggest that risks which are important are partly reflected in prices, which is not necessarily the case in other markets.

The Russian conflict in Ukraine is accelerating the shift in the world: yes, inflation will be higher and less transitory than expected, yes, we will have to assess returns in nominal and real terms, yes, globalization driven by Western liberalism is evolving into to regional blocks with various influences. Portfolios will have to continue to be adapted in an environment where diversification remains a must.

CHART 3: CHINESE EXPORTS IN USD BLN



Source: Bloomberg, Banque Eric Sturdza

3. FIXED INCOME MARKETS
ONLY ONE SINGLE FOE, INFLATION.

The Fed's first rate hike

The Fed has decided to break inflation "whatever it takes" and seems ready to sacrifice growth to achieve its goals. A first increase of 25 basis points of its Fed Funds rate (against probably 50 expected before the conflict in Ukraine) marks the starting point of an impressive series of rate hikes for 2022 aiming at breaking the inflationary spiral. This year, we will therefore be entitled to six more rate hikes of 25 points each, or a little less in the case of a mix of 25 and 50bp hikes. The level of Fed funds at the end of the year should then be 1.75%-2% compared to 0.25%-0.50% today. But that's not all! The next meeting on May 4 could draw the contours of the QT (Quantitative Tightening) designed to reduce the size of the Fed's balance sheet. The central bankers in Washington are therefore visibly confident in the US economy, in the limited impact of the Ukrainian crisis or its rapid resolution, and in limited further economic effects of the Covid pandemic. There is only one proclaimed enemy, inflation, and the central bank will use its weapons of mass destruction to defeat it.

Rates are rising but the curve is jerking, which does not fool many people. Frequent mini-inversions (3-5 years, 5-10 years or 5-30years) probably foreshadow much more significant movements and announce what is likely to happen, namely a real inversion of the 2-10 years. These expected significant rate hikes could trigger a yield curve inversion, synonym of a recession and it is the possible recession that could potentially overcome inflation. The markets are already looking at a first rate cut by the Fed at the end of 2023.

Investment strategy

The US Treasuries yield curve will flatten or even invert, but bear flattening means bear. Excessively high levels of duration have become dangerous in the current context and while we remain in favor of a homeopathic dose of 30 years in portfolios, we make sure that it remains homeopathic! We are significantly reducing the overall duration, particularly on the 10-year part by using hedges on the futures markets.

The US Treasuries yield curve will flatten or even invert, but bear flattening means bear.

Hybrid credits now offer stratospheric returns and still have a prominent place in our portfolios. But they are now outperformed in terms of risk-adjusted return by senior investment grade debt in dollars.

With higher short Treasuries rates combined with significant spread spreads, high quality dollar-denominated corporate debt with a 2.5 to 3 year maturity offers yields close to 3%. Today, we are therefore favoring investments in short-duration credits. A door is opening, let's go before it closes!

4. EQUITIES

"I DON'T HAVE A FAVORITE, I HAVE A PORTFOLIO"

STANLEY DRUCKENMILLER

Regular readers of this column know will have noticed our tendency to search for words of wisdom from the giants of our profession, especially during challenging times. Sidestepping Warren Buffett for once, we turn this time to another sage, Mr. Druckenmiller, known for his exceptional flair in macro investing. Pressed on his "top recommendations" a few years back, his simple yet powerful answer cited above stresses the importance of diversification even in his notoriously conviction-based investment style. Amid equity market volatility and arguably low visibility for financial markets, we find this message especially topical.

To describe the month of March as volatile would be a grave understatement. On the back of the Russian invasion of Ukraine, equity markets reacted violently to the uncertainty generated by such a historical turn of events. Europe bore the brunt of the volatility with the early days of the month experiencing large daily drawdowns and a spike in the cost of insuring equity risk, to finally rebound towards positive month-to-date performance at time of writing. Fears of deteriorating relations with China catalyzed a stark selloff in the region as well, later partially reversed by strong words from the Chinese government on its intention to stabilize markets. All in all, fundamental uncertainty gripped market participants, especially given the implications of current dynamics on what was supposed to be the challenge of the year, i.e. inflation and monetary policy. Given this limited visibility, equity markets' rebound has been striking and likely reflects, as discussed last month, a mixture of an existing bearish sentiment combined with the anticipatory nature of markets, now focused on migrating towards less inflation sensitive asset classes including equities.

In such unpredictable times, the key is diversification, both at the asset class and portfolio level, even if high conviction investments are reinforced. With this in mind, in our view, investors should consider different dimensions of diversification within equities, including:

Geography

Europe's proximity to the conflict, combined with its strategic energy vulnerabilities call for diversification to other geographies. Beyond the US, this includes notably Japan, a powerful economy geared towards exports in a weaker currency and few risks of inflationary headwinds, and China, the country with unique potential for monetary and fiscal stimulus, historically low valuations and limited economic growth risks. We continue to recommend geographical diversification throughout our equity grid.

Industry

a more restrictive monetary policy in the western pressures secular growth companies from a relative attractiveness perspective, while a return of a strategic infrastructure, energy and defense policy likely catalyzes a upwards cycle in some under-owned, more traditional and cyclical areas of the market. We continue to favor existing satellite vehicles focused on those areas and introduce investments in mining companies focused on the energy transition theme within our grid.

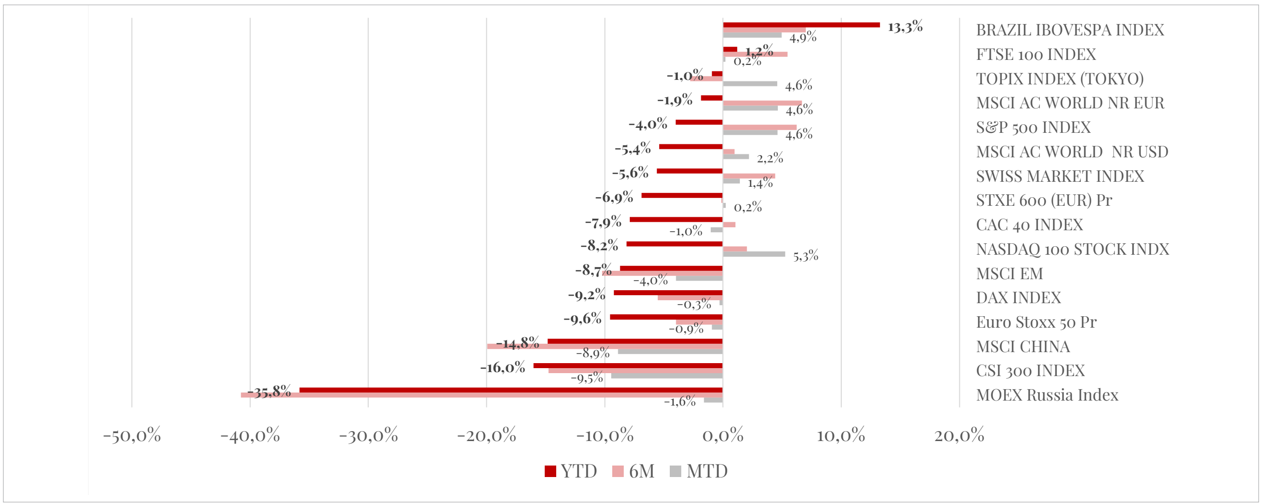
Valuation profiles

valuations reflecting growth expectations and uncertainty, limited visibility calls for a diversified set of assets priced with varying expectations, contributing to lower overall volatility. Within markets, we favor additional diversification by increasing lower nominal valuation assets, including such as those provided by more "value" investing styles in Japan.

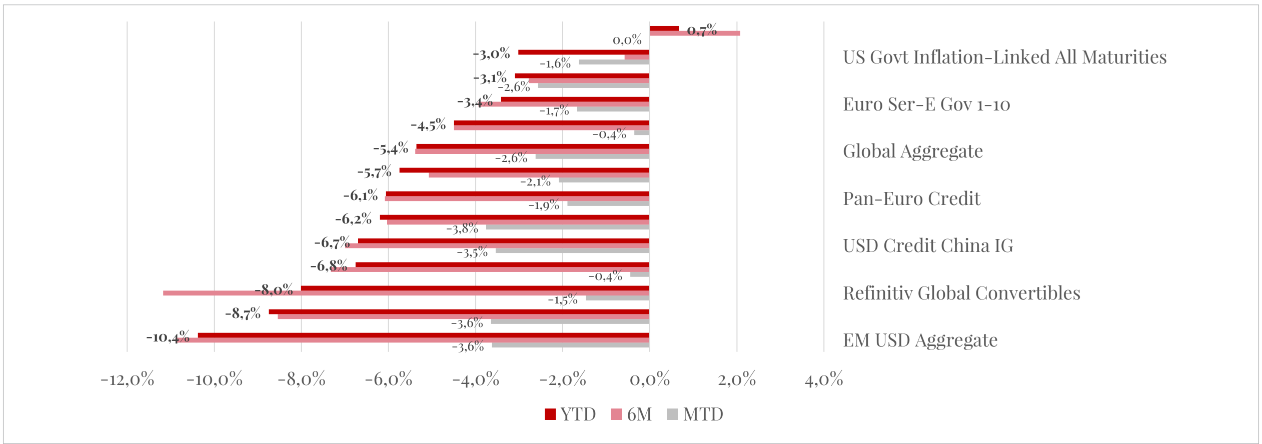
Equities are a cornerstone of investment portfolios, and continue to offer long-term value as an asset class. Given the general uncertainty and the many possible scenarios over the months ahead, it is difficult – or even arguably foolish – to focus on today's favorites. Instead, in the words of Mr. Druckenmiller, we choose to have a portfolio. Diversification is a must more than ever in order to balance bouts of volatility while capturing long-term returns from companies that are direct enablers of our everyday life.

5. PERFORMANCES

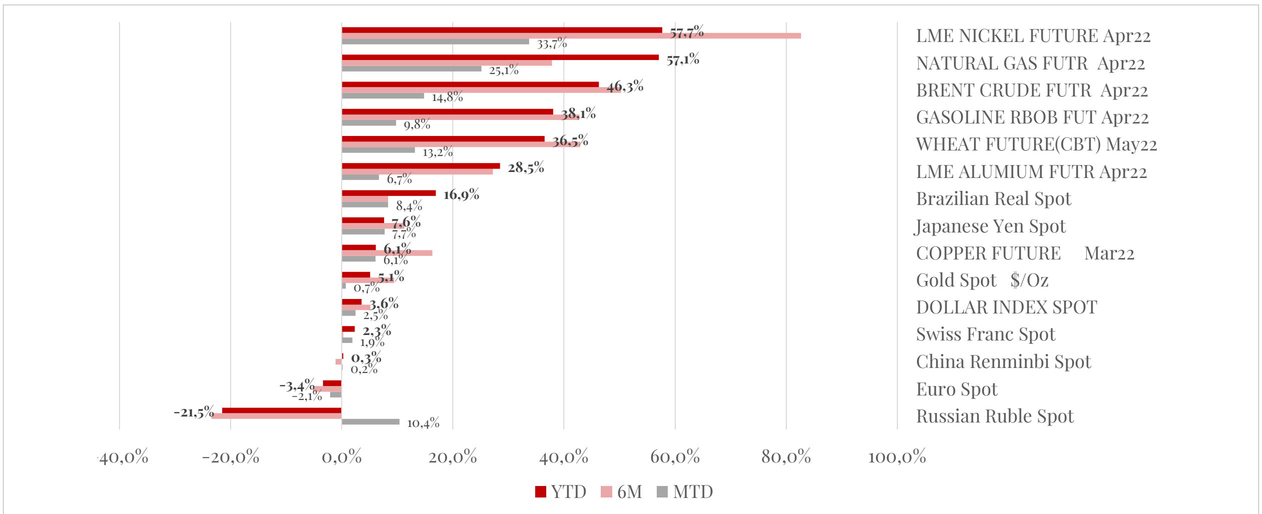
EQUITIES IN LOCAL CURRENCIES



FIXED INCOME



COMMODITIES AND CURRENCIES



Source: Bloomberg, Banque Eric Sturdza, 28/03/22

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