BANQUE
ERIC STURDZA

QUARTERLY OUTLOOK

2ND QUARTER 2023

CONTENTS

2ND QUARTER 2023

1. Editorial

"How did you go bankrupt? Two ways. Gradually and then suddenly." *

2. Macro focus

"Only when the tide goes out do you learn who has been swimming naked" **

3. Fixed Income

Inflation, bank failures and recession.

4. Equities

Fundamentals vs. Confidence.

5. Asset allocation

Reserved for Banque Eric Sturdza's clients

6. Performances

* *Ernest Hemingway, The Sun also rises*

** *Warren Buffett*

1. EDITORIAL

*"HOW DID YOU GO BANKRUPT? TWO WAYS. GRADUALLY. THEN SUDDENLY."**

The results of the past quarter look reasonable. Long-term interest rates eased (the US 10-year is at 3.55% compared with 3.85% at the start of the year), oil fell while equities rose with – as is often the case - significant discrepancies. The Nasdaq and the large technology companies are soaring (+20% year to date), Europe is outperforming (+7.8% for the STOXX600 against +7% for the S&P500) and China, although recently reopened, still lags.

These good results contrast with the disparity and suddenness of the events of the past three months. There were so many setbacks that fixed income investors may be forgiven for feeling that this quarter lasted 12m. It is worth remembering that prior to the debacles of some US banks and then Credit Suisse, the main performance driver was the final level of the FED's key interest rates and, more generally, the inflation issue (should the Federal Reserve do more? And what was the target interest rate level?) At the time when the banking problems erupted, these issues had not been resolved and left the fixed-income markets very nervous.

And then came several crashes in the US banking sector... Market regulators quick to intervene to prevent a bank run (an estimated $600 billion outflow from the system), and the Fed expanded its balance sheet. Within a few days, priorities had reversed: the fight against inflation had to be ignored, US depositors had to be reassured, and liquidity was once again the key word.

Closer to home, Credit Suisse, whose business model had been questioned for years, saw the ground crumble beneath its feet. The management certainly remembered a famous Ernest Hemingway dialogue: *"How did you go bankrupt? Two ways. Gradually, and then suddenly."*

Here too the issue was dealt with in a weekend... On both sides of the Atlantic the lessons of 2008 had been learned: Never let mistrust in the banking sector to take hold.

The FED always "breaks" something when it has to raise its rates. Today is no exception to the rule.

The incidents described above bring back bad memories: could we find ourselves in a 2008-type death spiral? The question needs to be answered as to whether there is any chance that the second quarter will continue in the same vein as the first. At the risk of being too consensual, the European banking sector appears to be much more solid than in 2008, liquidity ratios are higher (LCR** of around 150% at the sector level), balance sheets are less leveraged and there is certainly not a mass of " bad" assets as there were in the subprime crisis... That is not to say all difficulties are behind us. The US commercial real estate sector is under pressure, and the situation of some medium-sized banks remains problematic ... As an old stock market expression says, the FED always "breaks" something when it has to raise its rates. Today is no exception to the rule: in 2022, there were already some damages in the crypto-currency universe and the Silicon Valley Bank collapse has delivered a brutal lesson in the effects of bond duration and the risks of poor asset liability management.

There will surely be other victims, but the relative quietness of the equity markets over the last few days makes sense (we are still far from a panic scenario, the VIX, for example, has only very temporarily crossed the 25 mark).

Still, we should not forget that the easing of monetary conditions mentioned in the first part of this article was only due to a series of banking crashes. As contradictory as it may seem, the recent surge in technology stocks (which are very sensitive to rates) is the direct result of the collapse of a bank dedicated to funding technology stocks and start ups! One more conundrum and an incentive to keep exposures balanced between growth stocks, supported by the fall in rates, and other, less sensitive to this theme.

* *Ernest Hemingway – The Sun also rises*

** *LCR: The Liquidity Coverage Ratio seeks to ensure that banks hold sufficient high quality liquid assets (HQLA) to enable them to survive a liquidity crisis of 30 calendar days.*

2. MACRO FOCUS

*"ONLY WHEN THE TIDE GOES OUT, DO YOU LEARN WHO HAS BEEN SWIMMING NAKED"**

Warren Buffet's adage has rarely seemed more appropriate, with the Fed's rapid rate hike (the tide going out) pointing to several areas of weakness whether through cascading bankruptcies in the crypto universe last year and the failure of SVB in 2023.

Inflation and economic outlook

The first quarter started off quite well. With natural gas prices falling as a result of smart inventory management and mild winters, the Eurozone began to believe in a soft-landing scenario. In the United States, disinflation seemed well underway and the overall robust macroeconomic data gave reason to hope that 1- a halt in the Reserve's rate hike cycle and 2- that the rise in short-term rates was enough to slow down the economy without triggering a hard recession. This renewed optimism is not unconnected with the market rebound at the beginning of the year and the upward revisions of the growth outlook for 2023 (half a percentage point of additional growth expected for the US and the Euro area between now and late 2022).

The solid payroll figures coupled with robust wage growth revived the fears to see inflation remaining higher. These developments led investors to anticipate a higher terminal rate for FED funds and for a longer period.

Banking stress and recession risk on the rise

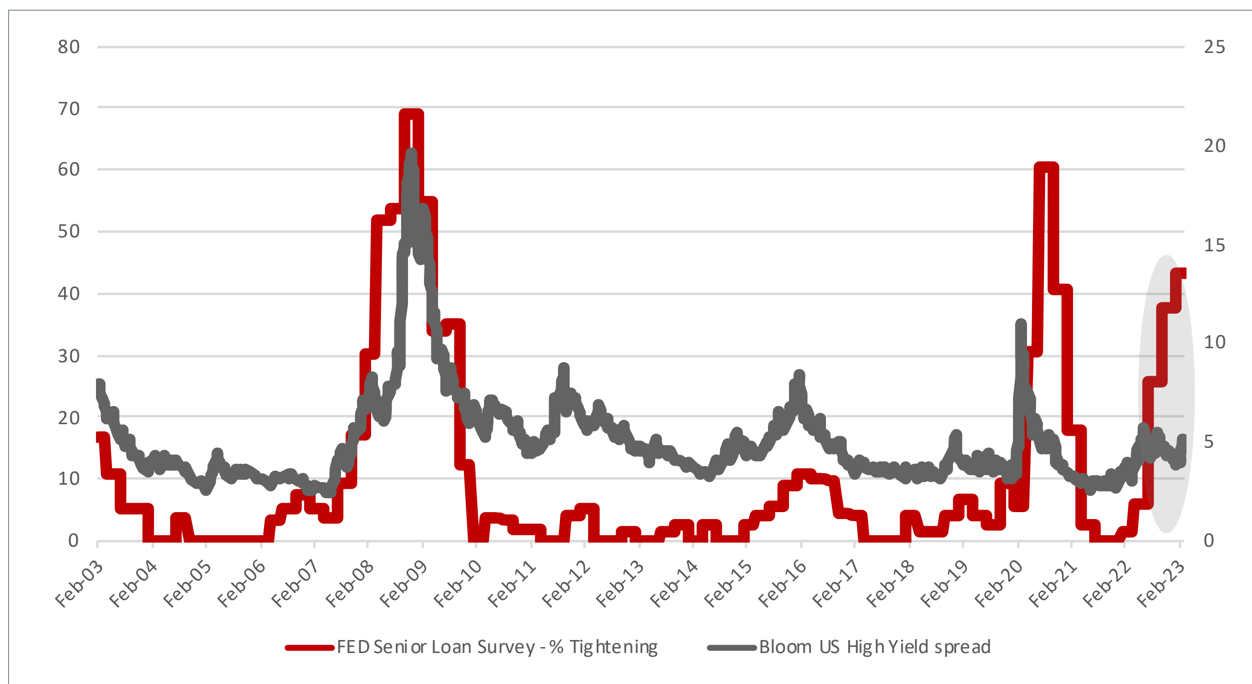
The macro upturn at the beginning of the year proved to be short lived. The cascade of bankruptcies of Silicon Valley Bank, a bank catering to venture capital and start-ups, and Signature Bank, with cryptocurrency depositors, not to mention the forced sale of Credit Suisse, are casting a serious shadow and creating a wave of panic in the financial markets. To stem this crisis of confidence, the monetary authorities, after having played the role of pyromaniac firefighter, have no other option than to open the floodgates of liquidity and to act promptly and decisively to safeguard the banking system.

The FED finally delivered a 25bp hike (against 50bp expected a few days earlier), and suspended the reduction of the size of its balance sheet. The loss of confidence in US regional banks spread to European banking institutions for which confidence was already shake. Credit Suisse, undermined by past scandals, had to be taken over in extremis by UBS in a transaction orchestrated and supported by the Swiss authorities.

The first action of a bank facing difficulties is to curtail access to credit at the risk of pushing the economy into recession in a self fulfilling prophecy.

While banking stress is reminiscent of past crises for some, the situation is very different from 2008's credit crisis, the sovereign debt crisis in 2011 or the 2020's COVID crisis. Banks are now better capitalised, regulated (in Europe) and are usually in a more favourable liquidity position. The good news is that confidence can be restored but in the long run. The good news is that confidence can be rebuilt, but over the long term. In the meantime, one of the risks to be monitored is that of a "credit crunch", particularly in the United States, where the role of the regional banks in funding the econo-

GRAPH 1 : FED LOAN SURVEY - % INDICATING A TIGHTENING OF LENDING CONDITIONS (LHS) VS. US HIGH YIELD AVG SPREAD (RHS)



Source : Bloomberg, Banque Eric Sturdza

my is crucial. Let's keep in mind that the first action of a bank facing difficulties is generally to curtail access to credit at the risk of pushing the economy into recession in a self fulfilling prophecy.

In this very particular environment, we believe it is important to maintain a relatively cautious and diversified allocation, with a strong focus on Asia, which remains a relatively " decorellated" zone from the current turmoil. Recessionary risk is back in the spotlight and inflationary risk is taking a back seat. The collateral damage of the end of free money is probably still to come. These are good reasons to remain vigilant, while remaining ready to seize the opportunities that will arise.

* *Warren Buffett*

3. FIXED INCOME

INFLATION, BANK FAILURES AND RECESSION.

Bullish steepening

At the very beginning of the month, inflationary fears were on the rise and the markets expected strong measures from central banks. But in the wake of the SVB crisis and the Credit Suisse debacle, the solidity of some banks and the stability of the financial system were called into question. The flight to quality benefited government bonds, with yield curves evolving in the form of a "bullish steepening" (short rates falling even more sharply than long rates).

In this context, the central banks were eagerly awaited. The ECB did not balk at raising its key rate by 50bp because inflation remains the main concern and, according to ECB President Christine Lagarde, the only concern since the financial system in the euro zone shows no signs of weakness. In the US, beyond the Fed's symbolic 25bp rate hike, it is indeed the sudden increase in size of its balance sheet that struck investors. The balance sheet increased by 392 billion within a few days, even though the quantitative tightening program is still being applied at the same pace. The BTFP (Bank Term Funding Program) is responsible for this sharp rise, as it is designed to provide liquidity to the system through massive injections of cash. This was obviously the price to pay to avoid turning the SVB bankruptcy into a major financial crisis.

Beyond the Fed's symbolic 25bps rate hike done by the Fed, it is indeed the sudden increase in size of its balance sheet that struck investors.

Duration up, credit exposure down

In such an environment, it was necessary to protect portfolios by favouring duration through exposure to long-dated government bonds. This more defensive strategy consists of adding a little more duration risk to the detriment of credit risk. There are two good reasons to invest in 30-year US Treasuries today.

First, exposure to the very long end of the curve is justified by an analysis of the current environment that argues for an overweight in long-term US government bonds. Secondly, 30-year US Treasuries have always acted as a natural hedge against riskier and more volatile markets such as equities but also, within the bond asset class, so-called "high beta" debt such as BBB/BB rated credits or hybrid bonds. These non-government debts will undoubtedly experience more volatility in the short term, but their high yields they offer argue in favour of continuing to hold them as part of a medium- to long-term strategy.

4. EQUITIES
FUNDAMENTALS VS. CONFIDENCE

Economic cycles are punctuated by periods of turbulence that seem to occur more and more frequently over the past 15 years. Crises now follow one another very quickly and even when all possible scenarios seem to have been anticipated, the infamous "Black Swan" is never far away. This reminds us of the extent to which the economy and the markets are exposed to certain unknowns that are not always rational...

Trust is a complex, multidimensional process that refers to the belief that a person or entity is reliable, knowledgeable, and behaves in a manner consistent with our expectations. This is the trust in financial and banking institutions that we are talking about today. We are not returned to 2008. Banks have since gone through rounds of regulation and are now well capitalised. Capital and liquidity ratios are strong and can easily handle the most severe stress scenarios, frequently simulated by central banks. On the other hand, poor risk management can destabilise an institution, whether it is sound or not. That was the case with the Silicon Valley bank, which led the way and highlighted its concentration risk in the Tech industry and a major mistake in managing the bank's assets and liabilities.

Confidence is fragile and vulnerable to breakdowns. In such cases, it is not easy to rebuild it and it needs time and effort to do so. The vulnerability of some large institutions was known to the market as evidenced by their level of Credit Default Swaps (CDS) before March. The particular risks of some institutions were clearly identified, especially in Europe. Credit Suisse, for example, had suffered from a number of crises and numerous changes in its management team over the past few years. Its capital ratios seemed sufficiently solid, but it was hard to defend against a crisis of confidence when the bank found itself with a run on deposits. The risk today seems to us to be more prevalent in the United States and concentrated in its non-systemic, regional, less regulated banks, whose activities involve significant risk concentrations in certain segments or types of customer.

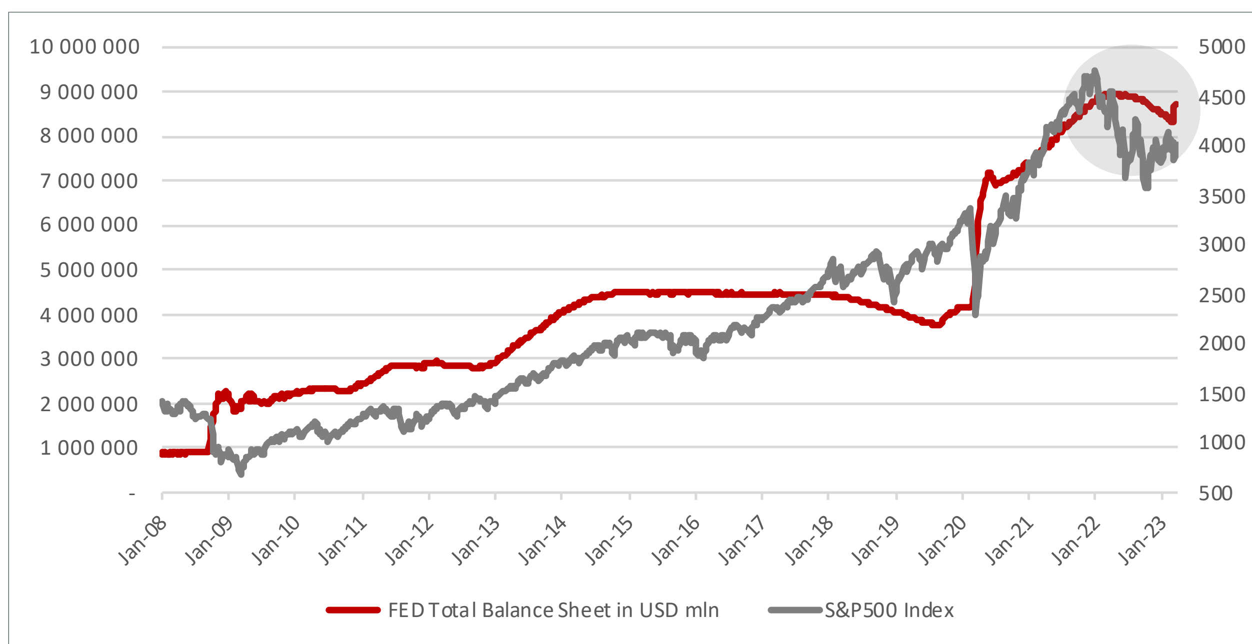
The Nasdaq tops the ranks with an impressive performance of +20% YTD. In the turmoil, investors seem to have found a new safe haven.

One of the concerns today comes from the "snowball effect" known as self-fulfilling prophecy which can form during crises of confidence and panic waves. It would be hard to rein in, would have no basis in fundamentals and would lack objectivity. To avoid such a situation, central bankers are acting in unison. They reassured and backed the banking system on both sides of the Atlantic. The "Quantitative Tightening" initiated by the FED is coming to a halt (chart below).

What are the impacts for the equity markets?

The market initially took the brunt of the blow and retraced most of its rise from the beginning of this year. In mid-March, after the FED and the ECB took note of the situation, reassuring and backing the financial system with hundreds of billions of dollars, equity markets rallied (MSCI World +3.8% YTD on 28 March). The stocks that were hit the hardest in 2022 are now rising. The undervalued stocks that were prized last year are being dumped in favour of technology companies. The Nasdaq tops

GRAPH 2: FED'S BALANCE SHEET IN USD MLN (LHS) VS. S&P500 (RHS)



Source: Bloomberg, Banque Eric Sturdza

the ranks with an impressive performance of +20% YTD. In the turmoil, investors seem to have found a new safe haven. The European market remains healthy and slightly ahead of the S&P500, largely supported by the performance of French large cap stocks, the CAC 40 index. This situation contrasts with the social tensions in France.

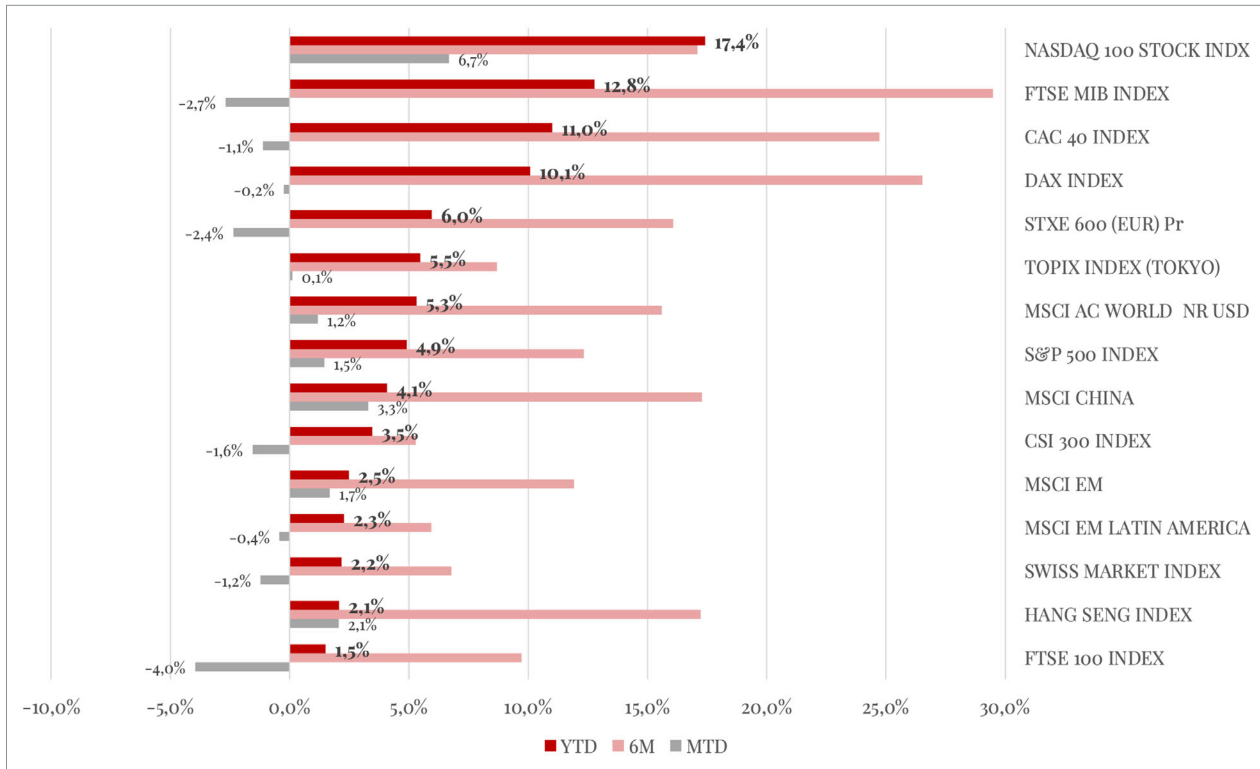
The US economy is doing well, it continues to surprise positively as reflected by the Citi Economic Suprise Index and contrary to the same indicator for the European economy which has been on a downward trend since the beginning of the year. However, in light of the recent macroeconomic and geopolitical events, and with an increaseing likelihood of recession, the US market looks expensively valued. (S&P500 PE 18x vs long term 17x).

The "Bull Bear" ratio, which we use as a contrarian indicator, is nonetheless coming close to levels where we could see the "Bear" capitulate.

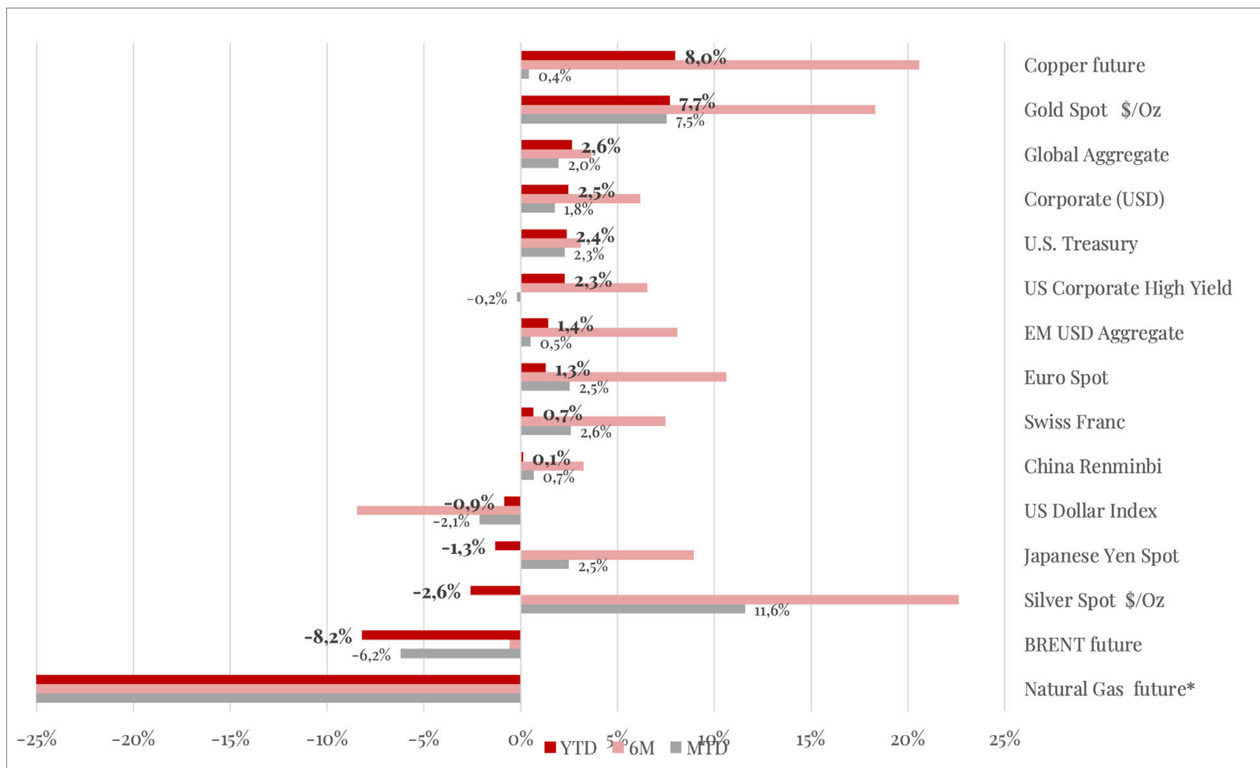
We remain cautious on equities and continue to favour a blended approach favoring both investments in selected value stocks and Quality Growth segments in our portfolios. Our focus remains on Asia (China, Japan and India). We favour an asymmetric approach through the use of derivatives (Long Short Strategies, Structured Products).

6. PERFORMANCES

EQUITIES IN LOCAL CURRENCIES



FIXED INCOME, CURRENCIES AND COMMODITIES



Source : Bloomberg, Banque Eric Sturdza, 30/03/2023

** Natural Gas : -55.5% YTD, -70.6% 6M, -27.5% MTD*

Legal information

This document intends to provide information and opinions on different matters. It is intended only for this purpose. This document does not constitute an advice, an offer nor a solicitation by Banque Eric Sturdza S.A. or on behalf of Banque Eric Strudza S.A. to buy or sell any financial instrument or to subscribe to any financial instrument. This document does not contain any recommendation personal or generic and does not take into account the investment objectives, financial situation or needs, or knowledge and experience of any persons. This document does not contain any offer or any solicitation to purchase or subscribe to any financial services or to participate in any financial strategy in any jurisdiction. It does not constitute an advertisement or an investment recommendation or a research or strategy recommendation. Moreover, it is provided for informational and illustrative purposes only and does not contain financial analysis. This document mentions and presents benchmarks which may only be used for comparison. The information provided must not be relied on and must not be the only source to make a decision about financial investments. It is also not a legal or tax advice, or any recommendation about any kind of financial services and is not intended to constitute any kind of basis on which to make a decision on a financial investment. Banque Eric Sturdza SA is not responsible and may not be held responsible for any loss arising from decision taken on the basis of the information provided in this document or for any liabilities arising from such decision. Although all due diligence has been performed to ensure that this information is accurate at the time of its publication, no guarantee is given regarding its accuracy, exhaustiveness or reliability. The information provided may change, even immediately after publication and there is no obligation to provide an up to date information at any time. Furthermore, the information provided in this document do not intend to provide all the legal and necessary information on financial instruments or on issuers. Other publications from Banque Eric Sturdza SA may in the past or in the future reach different conclusions from the information contained in this document. Furthermore, the present document and the information provided do not in any way engage the responsibility of Banque Eric Sturdza S.A., its affiliated companies, or its employees.

Information on risks

Investments are subject to a variety of risks. Before taking any decision of investment or entering in any transaction, any investor should request detailed information on the risks associated with the decision of investment and with the financial investment. Some type of products are in general bearing higher risks than others but general rules cannot be relied on. It is remembered that past performance is not a reliable indication of future results and that historical returns and past performance as well as financial market scenarios are not reliable indicator of future performance, significant losses remaining always possible. The value of any investment depends also on the fact that the base currency of the portfolio is different from the currency of the investment subject to the foreign exchange rates. The exchange rates may fluctuate and adversely affect the value of the investment when it is realized and converted in the base currency of the portfolio.

Distribution information

This document is not directed towards specified jurisdictions or toward specific person or entity resident in a specific jurisdiction and doesn't constitute any act of distribution, in jurisdiction where such publication or such distribution is contrary to the applicable law or regulation or would be contrary to any mandatory license requirement. This document is provided for the sole use of its recipient and must not be transferred to a third person or reproduced.

We are renovating our main building. In the meantime, we are happy to welcome you in our temporary offices.

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

Sent to press on 30/03/2023

Contact

Banque Eric Sturdza SA

Edouard Bouhyer

invest@banque-es.ch

www.banque-es.ch