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Investment Policy

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Key points

Monetary and fiscal policy

Central banks in the leading developed economies have made a clear choice, confirmed at their Jackson Hole symposium: they are all willing to **sacrifice** economic growth in order to curb inflation (**Chart 1**). However, we are witnessing some **divergence** between **economic policies** being adopted by the various governments.

In the **US**, the equation is quite **straightforward**: to combat overfast inflation (8.3% YoY), the Fed is quickening the pace of rate hikes, raising rates 75 bps at a time (from 0.25% in January to 3.25% in September), while downsizing its balance sheet, without any particular reinforcement on the budgetary front. The policy mix is thus restrictive: the authorities are all pulling in the same direction. The situation is similar in Switzerland, where the SNB is above all keen to safeguard the value of the Swiss franc against a backdrop of worldwide inflation, without help from the government.

The same cannot be said of the **eurozone**, where the ECB's job is not only more **complex** but also looks set to be **less effective**: almost half of inflation is being driven by energy prices, which no central bank can influence. Furthermore, the ECB's efforts are partly being cancelled out by government subsidies (equating to several percentage points of GDP). Another thing rendering the ECB's task more complex is the fact that inflation rates vary significantly from country to country and, unlike other central banks, the ECB must take into account the risk of fragmentation (widening of yield spreads on the weakest countries). That said, it too raised rates by 75 bps in September.

The **opposing stances** adopted by authorities – tightening by the ECB and easing by governments – are complicating matters and, paradoxically, could result in Frankfurt having to go even further to achieve its target. In any event, this divergence in the European policy mix is fuelling greater **uncertainty** as to when interest rates will peak in the current cycle.

Scenario and conclusions

- Authorities' priority is managing inflation
- Energy crisis in Europe will dampen economic activity
- Risk of recession sometime in 2023 is high on both sides of the Atlantic

→ **Equities**: underweight given risk to economic activity

→ **Bonds**: maintain short duration; preference for investment-grade corporate bonds

→ **Currencies**: increase USD; preference for USD and CHF

→ **Cash**: overweight

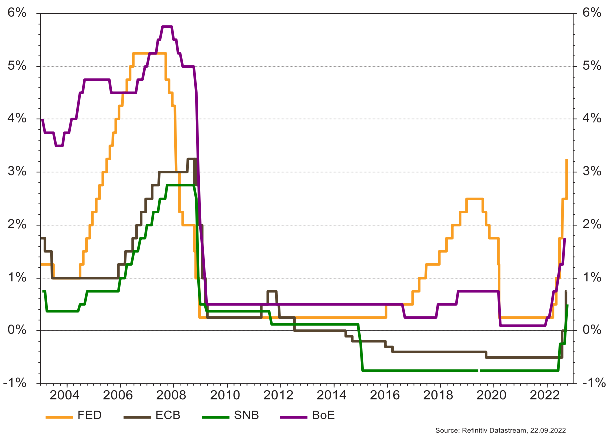
	UW (-)		N (=)		OW (+)
Asset allocation					
Equities		■			
Sovereign bonds		■			
Credit		■			
Alternative investments				■	
Cash					■
Equities					
US			■		
Europe		■			
Switzerland				■	
Japan		■			
Emerging markets			■		
Bonds					
Sovereign		■			
Corporate investment grade				■	
High-yield corporate	■				
Emerging market sovereign (USD)	■				
Emerging market sovereign (local)	■				

Economy: *winter is a worry…*

Technically speaking, the **US** economy slipped into recession in H1, with GDP down 1.6% QoQ in Q1 and 0.6% in Q2. However, while investment did indeed decline in Q2, domestic demand – and particularly consumption – continued to grow in H1. Given the current monetary tightening, the future is looking less bright. Not surprisingly, **housing** has been the first sector to suffer the effects of rising interest rates. Mortgage rates have gone up from 3.2% at the start of the year to over 5.5% (their highest since 2008), prompting a 20% drop in new mortgage applications. Confidence among homebuilders has also waned. The number of home sales has been falling, as have volumes of new construction. At the same time, the stock of unsold new homes has increased. Prices – resilient for the time being – are also going to have to come down, which will dent consumer confidence.

While the housing sector is probably already in recession, the same is not true of the rest of the economy. Although PMI numbers have been on the slide, they are still high enough in manufacturing and service sectors alike to make sure the cycle runs on for the rest of this year. Similarly, **labour market** momentum will support consumption for some time yet. Corporate America has added an average of 438,000 new jobs a month since the beginning of this year, and wages are up 5.7% YoY.

Chart 1 | Central banks – Pace of rate hikes is quickening



Lastly, **inflation** – by far the overriding concern – has probably peaked (9.1% in June). Energy prices are no longer accelerating and supply chain pressures are easing. Some tensions remain, however, particularly in the service sector, as a result of rising wages, which are preventing inflation from slowing as quickly as some had hoped. At this stage, it seems inevitable that, if inflation is to be slowed sufficiently, demand will have to be destroyed – which means **recession**.

The main cause for concern in **Europe** is the ongoing energy crisis. The alarmist tone adopted by politicians (such as references to "the end of abundance") could form part of the answer by encouraging users – voluntarily for the time being – to cut back on their electricity and gas consumption. The target of rebuilding **gas reserves** ahead of winter has been exceeded (with reserves nearly 90% full, vs. an initial target of 80%) thanks to efforts by part of the industry (which, where possible, has replaced gas with coal). Will it be enough to get through winter? Perhaps, though there is much uncertainty and many factors will depend on how severe the winter is (which will affect demand). What cannot be disputed is that, even if there is enough gas to go around, prices will stay high. Prices are running at multiples higher than they were last year (tenfold higher at their peak and three to four times higher today). The surge in electricity prices can be blamed partly on the price-setting mechanism, which constitutes a major handicap at times of extreme stress. Work is underway to overhaul the system but it will take time for this to be approved and implemented. Sizeable **public subsidies** to households and businesses, equating to around 3-4% of GDP, are essential if an economic slump is to be avoided. Moreover, the post-pandemic economic recovery extended into H1 (with

Financial markets

*) To 21.09.2022	Performance			Valuation			Earnings growth			
Equity markets	Price (local currency)	Quarter Q3*)	Since 31 Dec 2021	12-month P/EPS	Dividend yield	Price/ net assets	12-month EPS	2022 EPS	2023 EPS	2024 EPS
United States	3 609.84	0.38%	-21.40%	17.18	2.1%	4.0	8%	8%	8%	9%
Europe	407.05	-0.04%	-16.60%	11.48	3.4%	1.7	6%	18%	3%	6%
Japan	1 920.80	2.70%	-3.60%	12.42	2.4%	1.3	8%	13%	3%	8%
Switzerland	10 429.40	-2.90%	-19.00%	15.71	3.0%	2.8	12%	4%	15%	10%
United Kingdom	3 973.75	0.83%	-5.60%	9.50	4.0%	1.6	4%	22%	0%	1%
Emerging Markets (USD)	932.08	-6.85%	-24.30%	11.17	3.8%	1.7	6%	10%	5%	11%
World (USD)	2 516.59	-1.16%	-22.10%	15.19	2.5%	2.8	7%	11%	6%	8%

Source: Datastream, IBES consensus

GDP up 2.7% QoQ in Q1 and 3.1% in Q2), outpacing US growth. Despite these interventions, a recent **IMF** report suggests that, if energy shortages really do bite, the eurozone economy could shrink by as much as 3%. While the **ECB's latest projections** are not as bleak as that, they do suggest growth will slow sharply in 2023 (with the bank downgrading its growth forecast from 2.1% in June to just 0.9% in September). The ECB has lifted its inflation forecasts (from 6.8% to 8.1% for this year and from 3.5% to 5.5% for 2023), meaning that it too is being forced into stepping up the pace of monetary tightening. Climbing interest rates and, above all, soaring energy costs have resulted in PMI numbers falling much more steeply than in the US. The level reached by some of them, particularly in Germany, now points to a faster **recession** than in the US (**Chart 2**).

Switzerland, which is not immune to the energy crisis besetting Europe, posted solid growth in Q2 (1.2% QoQ) thanks to a rebound in consumer spending. The country is protected by a strong currency that cushions it against the rising cost of living. Lower inflation in Switzerland (at 3.4% YoY) should also limit how far the **SNB** will have to hike interest rates.

Lastly, in **China**, the economic upturn is taking its time to materialise. The authorities have shelved their 5.5% GDP growth target; the consensus now is for 3.8%, which would be the **lowest rate of expansion since 1990**! Industrial production, retail sales and even investment have remained disappointing in the early part of Q3. In real estate, a crisis-plagued sector accounting for roughly 30% of Chinese GDP, new construction has plummeted by 45%! This has prompted the authorities to respond by directly financing some developments, buying up unfinished properties and reviving infrastructure investment programmes. Since Chinese inflation is low (at 2.5% YoY), the central bank can ease monetary policy and cut interest rates. Despite sticking with its zero-Covid policy, the world's second-largest economy is thus set to benefit from a **highly accommodative policy mix**. This is good news for the rest of the world too.

Chart 2 | Germany – Ifo confidence indicator is pointing south…

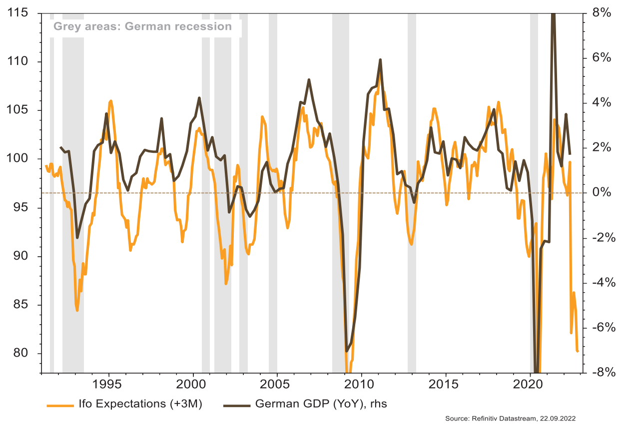
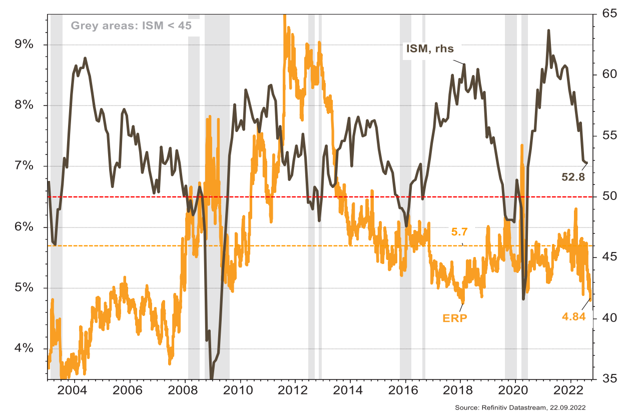


Chart 3 | Eurozone – Inflation rates vary but are all high!



10-year sovereign bonds	Level at 21.09.2022	Change Q3*) (bps)	Change since 31 Dec 2021 (bps)
USD yields – United States	3.51%	54	201
EUR yields – Germany	1.89%	52	207
JPY yields – Japan	0.25%	2	18
CHF yields – Switzerland	1.30%	34	143
GBP yields – United Kingdom	3.31%	111	234
Emerging markets (USD)	7.77%	14	312
Emerging markets (local currency)	4.31%	-15	48
Commodities	Price	Quarter Q3*)	Since 31 Dec 2021
Gold (USD/oz)	1 668.10	-7.7%	-8.5%
Brent (USD/bl)	88.91	-20.0%	14.0%

FX	Level at 21.09.2022	Change Q3*)	Change since 31 Dec 2021
EUR vs. CHF	0.9533	-4.76%	-8.00%
EUR vs. USD	0.9994	-4.38%	-11.70%
EUR vs. JPY	142.3739	0.24%	8.72%
EUR vs. NOK	10.1730	-1.51%	1.44%
GBP vs. EUR	1.1422	-1.69%	-4.12%
GBP vs. USD	1.1332	-6.69%	-16.34%
USD vs. CHF	0.9651	0.80%	5.92%
USD vs. CAD	1.3395	3.84%	6.04%
AUD vs. USD	0.6660	-3.16%	-8.40%

Source: Datastream

Monetary preferences

Rank 1	Rank 2	Rank 3
Appreciation expected	Stabilisation	Depreciation expected
USD | CHF | GOLD	JPY | NOK	EUR | GBP

Rank 1

- **USD** ↑: despite its high valuation, it is a source of yield and offers protection against geopolitical risk
- **CHF**: interest rates are rising; safe haven currency and hedge against global inflation
- **GOLD**: a currency hedge and a diversification asset

Rank 2

- **JPY**: very attractively valued after its sharp devaluation; a shift away from the country's accommodative monetary policy, while tricky, would have the potential to drive powerful gains
- **NOK**: stabilised now that oil prices have picked up

Rank 3

- **EUR** ↓: despite an attractive valuation, the ECB's rate hikes are not enough to make up for political risk (Italy) and risks arising from the energy crisis
- **GBP**: attractively valued but structural effects of Brexit not yet visible; BoE will struggle to curb inflation, which is higher than elsewhere

Investment conclusions

The economic and financial environment remains **unfavourable** to risk assets. On the one hand, leading central banks are raising interest rates and siphoning liquidity out of financial markets; on the other, economic activity is on course to deteriorate.

That being the case, the most **defensive** assets – namely cash and investment-grade bonds – have regained some value, whereas equities, being more dependent on the economic cycle, still look vulnerable.

Of course, with indices losing ground in the year to date and profits having so far proved resilient, valuations have deflated, though not to a level where the sort of slowdown we are expecting has been priced in. Moreover, with earnings growth set to deteriorate, the asset class does not offer attractive enough surplus returns over and above those available from sovereign debt (**Chart 3**). While equity markets will no doubt make further attempts to rally, the **trend remains bearish**. How a recession takes hold is not a one-off event but a process that unfolds over time, and markets will remain prone to uncertainty and volatility until a new economic cycle kicks in.

After initially lowering our exposure to the **dollar**, we moved back into it at the beginning of the quarter: despite being expensive, the dollar looks the only currency offering both yield and protection against geopolitical risk. The other currency we like, for the protection it offers against global inflation, is **CHF**.

We are therefore maintaining our **cautious** asset allocation and have made few changes. While it is still too early to lengthen bond duration (maturity), we need to be ready to do so. For the time being, short-duration investment-grade **corporate bonds** offer the most attractive risk-adjusted returns.

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