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Investment Policy

Q1 2023 | December 2022

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Key points

2023: the return of balanced portfolios!

Before 2022, there had only been two other years since 1926 when both equities and US Treasuries posted negative returns: 1931 and 1969. What might explain this market **anomaly** that hit the most conservative investors hardest?

This year began with **interest rates** particularly low after a decade of highly accommodative monetary policies – policies which, moreover, had been loosened even further during the pandemic. The **resurgence** in inflation, which was initially – and mistakenly – viewed as temporary, forced central banks to abruptly reverse their monetary policy course and raise interest rates. This U-turn pushed short-, medium- and long-term interest rates up for everyone – governments, businesses and consumers alike.

Now, rising interest rates mean falling bond prices. And with interest rates moving steeply upwards (10-year sovereign yields rose 2% in the US and Germany, and 1.2% in Switzerland), the **losses** were just as eye-watering (15% in the US and Germany, and 10% in Switzerland).

Given the higher risk associated with equities, the impact of rising interest rates on the asset class was, in the end, more modest, with losses of 'only' 17% in the US, 10% in Europe and 14% in Switzerland. Indeed, equities have – for the time being, at least – only seen their valuations fall as a result of this change of interest rate regime. That being the case, the most defensive portfolios have posted very similar returns to those with the most aggressive profiles – a highly unusual state of affairs. Now, though, **defensive assets**, which in the early part of 2022 had become too expensive to play their part in a portfolio, are once again offering potential. This is particularly true of investment-grade corporate bonds, where yields are at their highest since 2008/2009 (**Chart 1**).

Consequently, 2023 should see multi-asset portfolios regain their relevance, offering suitable returns for the most **defensive** investors.

Scenario and conclusions

- **Inflation** still the priority for central banks
- Fears of an **energy crisis** in Europe have abated
- Risk of **recession** sometime in 2023 is high on both sides of the Atlantic
- **Chinese** economy is picking up

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

→ **Bonds**: overweight; buy more investment-grade corporate bonds

→ **Currencies**: reduce USD; we continue to favour 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: *China – the 2023 wildcard?*

While many **economic activity** statistics are still satisfactory, leading economic indicators suggest the global economy will contract over the next few quarters.

In the **US**, Q3 growth turned out to be strong (with GDP up 2.9% QoQ annualised). Consumer spending was buoyant, funded not only from higher income from employment (with hourly wages up 5.1% YoY) but also from excess savings built up during the pandemic. However, households' surplus savings are being rapidly run down and, in real terms, disposable income is shrinking faster than ever (**Chart 2**). Slowing corporate earnings growth meant business investment made a negative contribution to Q3 GDP growth. The outlook is darkening here too, with earnings growth forecasts being downgraded. One sector of the economy already in recession is **housing**: it is, by definition, the sector most sensitive to rising interest rates. Following a slump in confidence among homebuilders and a decline in construction activity, prices have now begun to fall (down 2.2% since June).

Recession is spreading to the **manufacturing** sector, as evidenced by the ISM Manufacturing Index sinking below the 50-point mark (to 49) – i.e. into contraction territory – for the first time since the pandemic ended. The ISM Non-Manufacturing Index, which measures confidence in the services sector, is still firmly ensconced in expansion territory at 56.5: if, as we suspect, a recession is looming, this has not yet fed through.

However, it does look as if a recession will be needed to bring **inflation** back down to a more acceptable level. After peaking at 9% YoY in June, headline inflation slowed somewhat in November (coming in at 7.8% YoY), with the cooling of supply chain pressures and the slump in freight rates enabling manufactured goods prices to ease. Furthermore, this trend has been accompanied and facilitated by soft consumer price inflation (1.6% YoY in November) and producer price inflation (-1.3% YoY) in China. Nevertheless, services inflation is still high, and there will be no rapid decline in inflation as long as the labour market remains taut (with unemployment at just 3.7%). Moreover, history suggests that inflation will not return quickly to central banks' target levels: a recent

Chart 1 | World: investment-grade corporate bond yields once again attractive

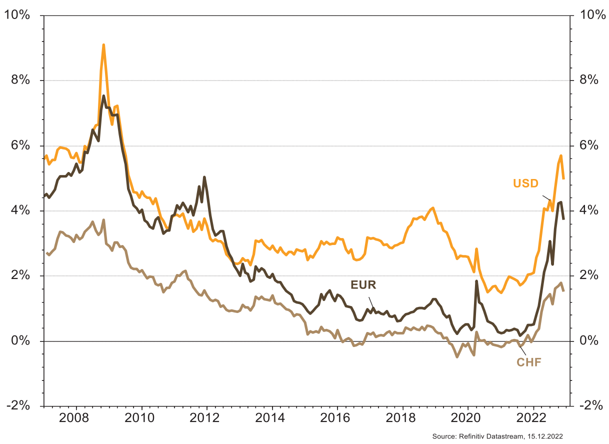
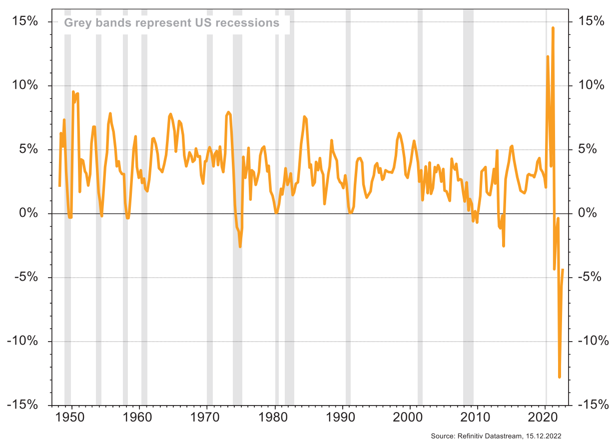


Chart 2 | US: record contraction in real disposable income



Financial markets

***) To 14.12.2022**	Performance			Valuation			Earnings growth			
Equity markets	Price (local currency)	Quarter Q4*)	Since 31 Dec 2021	12-month P/EPS	Dividend yield	Price/ net assets	12-month EPS	2022 EPS	2023 EPS	2024 EPS
United States	3 792.11	11.10%	-17.40%	17.48	2.1%	3.9	5%	7%	4%	10%
Europe	442.51	14.10%	-9.28%	12.26	3.4%	1.8	2%	19%	2%	6%
Japan	1 977.42	7.70%	-0.75%	12.21	2.6%	1.3	6%	12%	4%	7%
Switzerland	11 160.69	8.70%	-13.00%	15.86	3.0%	2.8	19%	-1%	19%	11%
United Kingdom	4 100.26	8.90%	-2.60%	10.05	3.9%	1.7	-3%	25%	-3%	2%
Emerging Markets (USD)	973.71	11.20%	-21.00%	11.61	3.8%	1.7	2%	8%	2%	13%
World (USD)	2 705.32	13.70%	-16.30%	15.49	2.6%	2.8	4%	11%	3%	8%

Source: Datastream, IBES consensus

study (by Research Affiliates, LLC) has shown that, when inflation tops 6%, it takes a median of seven years for it to drop back to 3%…

That said, the first signs of previous rate hikes filtering through to economic activity should prompt central banks to dial down the size of future hikes, both in the US and in other developed economies.

In the **eurozone** too, we have been witnessing the first tentative signs of inflation easing, down from 10.6% YoY in October to 10% YoY in November. The really good news for Europe has undoubtedly come on the energy front: although prices are still very high, the risk of shortages – still a major concern in late summer – has receded thanks to mild weather that has reduced gas consumption by more than 20% over the past few weeks. **Gas storage** capacity was 93% filled in mid-November; this should be enough to make it through winter without rationing. The problem is next winter: with no Russian gas supplies, will Europe have enough liquefied natural gas (LNG) capacity? With so many factors at play, this is a tough question to answer. While Europe has gained a few months' respite, it will remain energy-dependent for the foreseeable future.

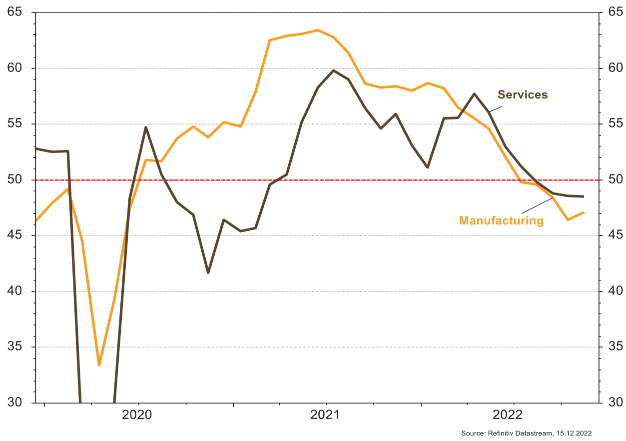
The effects of higher energy costs have caused confidence among purchasing managers to nosedive, not only in the manufacturing sector, as in the US (to 46.4), but also in services (to 48.6) in November (**Chart 3**). Similarly, consumer confidence is in the doldrums, which will adversely affect economic activity. However, growth was once again surprising in the third quarter, with GDP up 0.8% QoQ annualised for the eurozone as a whole (up 1.6% in Germany, 0.7% in France and 1.8% in Italy) and unemployment at its lowest since the creation of the single currency, coming in at 6.5% in October.

Switzerland also registered satisfactory growth in the third quarter (with GDP up 1% QoQ annualised), mainly thanks to strong domestic demand (consumption and investment, excluding construction). While the fact that inflation is more modest than elsewhere (3% YoY in November) will keep the **SNB** from hiking interest rates too far, the weakness of the international economy will not spare Switzerland.

In **China**, it was only a matter of days after Xi Jinping was re-elected as the country's leader that stimulus plans were announced. A programme to relax **restrictions** under the zero-Covid policy has been unveiled and a gradual reopening is on the cards. The acute social unrest currently besetting the country could indeed prompt the government to ease restrictions more quickly. A real estate support plan (for developers but above all buyers) is also in the process of being rolled out.

With developed countries slowing, an **upturn** in the world's second-largest economy would be a welcome stabilising factor for global economic activity.

Chart 3 | Eurozone: confidence among purchasing managers is crumbling



10-year sovereign bonds	Level at 14.12.2022	Change Q4*) (bps)	Change since 31 Dec 2021 (bps)
USD yields – United States	3.50%	-30	201
EUR yields – Germany	1.94%	-17	212
JPY yields – Japan	0.25%	1	18
CHF yields – Switzerland	1.15%	-9	129
GBP yields – United Kingdom	3.31%	-79	234
Emerging markets (USD)	7.36%	-112	271
Emerging markets (local currency)	4.43%	-3	60
Commodities	**Price**	**Quarter Q4*)**	**Since 31 Dec 2021**
Gold (USD/oz)	1 811.05	8.2%	-0.6%
Brent (USD/bl)	82.84	-4.8%	6.2%

FX	Level at 14.12.2022	Change Q4*)	Change since 31 Dec 2021
EUR vs. CHF	0.9835	2.00%	-5.08%
EUR vs. USD	1.0639	8.62%	-6.00%
EUR vs. JPY	143.5709	1.25%	9.63%
EUR vs. NOK	10.3888	-2.69%	3.60%
GBP vs. EUR	1.1651	2.17%	-2.20%
GBP vs. USD	1.2406	11.14%	-8.41%
USD vs. CHF	0.9237	-6.16%	1.37%
USD vs. CAD	1.3562	-1.30%	7.37%
AUD vs. USD	0.6866	6.78%	-5.57%

Source: Datastream

Monetary preferences

Rank 1	Rank 2	Rank 3
Appreciation expected	Stabilisation	Depreciation expected
CHF | GOLD	EUR | JPY | USD	GBP
▪ **CHF**: interest rates are rising; safe haven currency and hedge against global inflation ▪ **GOLD**: a currency hedge and a diversifying asset	▪ ↑ **EUR**: decline in political and energy risk should allow currency to enjoy a rerating ▪ **JPY**: very attractively valued; ditching current monetary policy would be a powerful trigger ▪ ↓ **USD**: valuation is high and spreads have stopped widening in the dollar's favour; still a source of protection against a global economic slowdown	▪ **GBP**: attractively valued but structural effects of Brexit not yet visible; BoE will struggle to curb inflation, which is higher than elsewhere; furthermore, new government's austerity plan will continue to dampen the economy

Investment conclusions

Volatility on the main financial assets is still high, reflecting two major opposing forces. On the one hand, the **economic** growth outlook continues to worsen, prompting financial operators to anticipate the end of monetary tightening – hence the decline in yields, consistent with such a scenario. On the other hand, risk assets – equities and high-yield corporate bonds – seem keen to ignore what is happening with economic fundamentals and simply take advantage of this decline in yields. This is causing their **valuations** to climb.

With economic activity poised to shrink, equities – especially in the US – look to us to be unjustifiably expensive, which is why we are keeping exposure below average in our allocations.

This is especially so considering that, in relative terms, the yield offered by investment-grade **corporate bonds** is much more in line with fundamentals and, therefore, less vulnerable. We have increased our exposure to this segment across all currencies while reducing our exposure to alternative funds, which are less attractive now that interest rates are higher. We have tweaked our regional **equity** allocation, nudging up our exposure to **emerging regions** (and China), which are less expensive and offer a brighter outlook, and lowering our exposure to the US.

Lastly, we are beginning to reduce **the US dollar** in our portfolios. The surplus returns it offers relative to other currencies are no longer rising, it has become expensive and the threat of an energy crisis in Europe, which was severely penalising European currencies, has diminished. The main argument in the greenback's favour lies in the fact that it almost always appreciates when a global economic slowdown is on the horizon. We think this eventuality has been partly priced into the dollar's already generous valuation and the currency now offers limited upside.

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