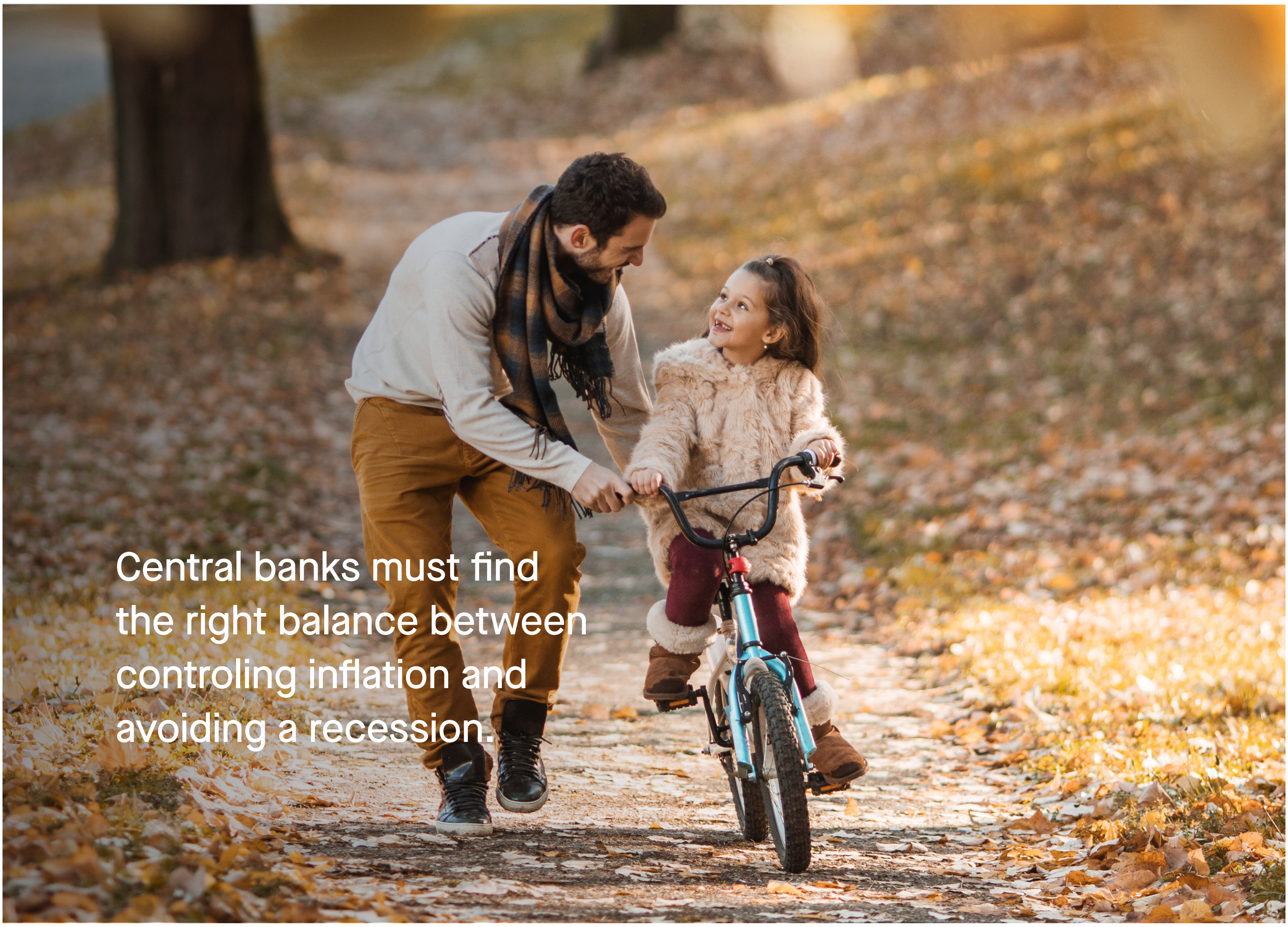
Market Outlook

WALKING A FINE LINE

H1/2023

Global growth slowdown and an end to 20 years of quantitative easing will change the face of finance in 2023.

PRIVATE BANKING


Central banks must find the right balance between controling inflation and avoiding a recession.

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INTRODUCTION

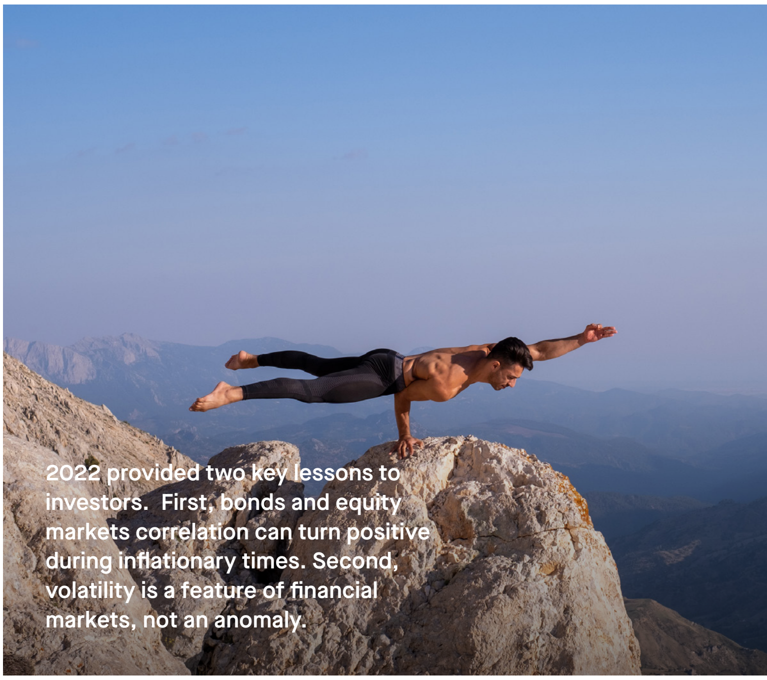
Finding the right balance

Global investors have very little to be thankful for in 2022. The traditional equity/bond portfolio recorded its worst performance since the great financial crisis, emerging markets tumbled, the vast majority of foreign currencies lost ground against dollar and cryptocurrencies were a blood bath. More importantly, 2022 provided two key lessons to investors. First, bonds and equity markets correlation can turn positive during inflationary times. Second, volatility is a feature of financial markets, not an anomaly.

With hindsight, the invasion of Ukraine by Russia in February will probably be remembered as turning point, not only for 2022 but also for the years to come. The East-West divide is likely to create more geopolitical tensions, it could lead to structural supply deficits in key commodities, it is accelerating the reshoring trend and is likely to keep macroeconomic and financial markets volatility relatively high. Ultimately, the winning asset classes of the last decade (high growth stocks, long duration bonds) will not necessarily keep their edge in the years ahead.

As we enter 2023, the key question for financial markets is whether central bankers will be able to cool down inflation without triggering a deep recession. As developed in our macro-economic outlook, we believe decision makers will indeed have to walk on a thin line to engineer a soft landing. Favorable base effects and a significant slowdown in goods inflation should be enough to bring down inflation to reasonable levels. Meanwhile, fiscal support and a resilient consumer are expected to keep global growth afloat.

As highlighted in our “Ten surprises for 2023”, there are tremendous uncertainties ahead, be it on the macroeconomic or geopolitical side. But there are also some opportunities. Let’s start with the obvious: over the last few quarters, there has been a paradigm shift from zero/negative yields to decent carry rewarding investors venturing into investment grade and high yield bonds. Provided the world doesn’t collapse into a deep recession, the risk/reward in credit looks compelling. Within equities, several companies with strong balance sheets and a solid economic moat are offering attractive free cash flow yields. It is also time for contrarian investing: non-US equities, commodities and hedge funds remain under-represented in global portfolios although they offer interesting diversification benefits. Last but not least, these highly uncertain times are also fertile in alpha opportunities, which implies that active management might come back into fashion.



While our forecasts and views are always subject to changes, especially in these highly uncertain times, our commitment to serve our clients is not.

We wish you a prosperous and healthy 2023.

Charles-Henry Monchau
Chief Investment Officer

2022
Market review

2022 was marked by geopolitical tensions, soaring energy prices and the end of years of QE which triggered global inflation. Here are 10 stories in the market to remember from this historical year.

STORY 1 —

Invasion of Ukraine

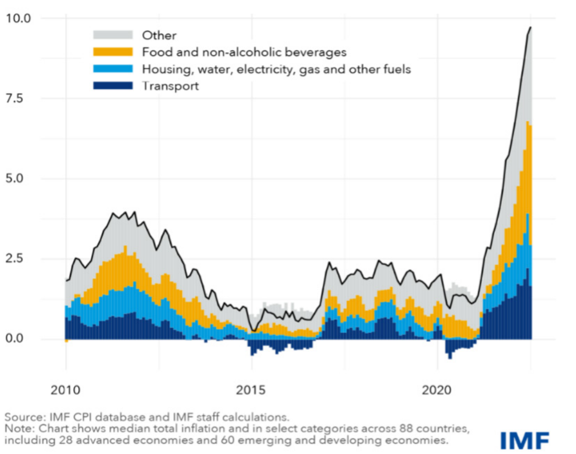
This is, without a doubt, the most dramatic and important development of the first half of 2022. Although a Russian incursion into Ukraine appeared plausible at the beginning of the year, Russian President Vladimir Putin's decision to carry out a full-scale war beyond the separatist region of Donbas stunned the world. Beyond the conflict's human tragedy, sanctions imposed by the West have far-reaching consequences for the global economy and monetary order. This episode of history comes at a time when the supply of raw materials is already insufficient to meet demand. Meanwhile, Russia produces and exports a vast majority of said raw materials: oil, natural gas, industrial metals, precious metals, and agricultural commodities. The global economy, therefore, faces a commodity supply shock, with consequences for both growth (downside risk) and inflation (upside risk). At the time of writing, a rapid end to the war, and therefore to the application of sanctions, seems unlikely. Even if an agreement is reached, the normalization of relations between Russia and the West may take years, for as long as President Putin remains in power.

STORY 2 —

The surge in inflation

Inflation has kept surprising on the upside, hitting multi-decade highs across the globe. US consumer prices jumped 8.5% from a year earlier in April to a fresh 40-year high on rising petrol, food and housing costs. The US continues to face strong rents and wage inflation. In Europe, Germany's inflation accelerated in May to 7.9% year-on-year, its highest level since the monthly statistic was first calculated in 1963. While the conflict's immediate impact on the world economy is expected to be limited (Russia's economy accounts for less than 2% of global GDP), rising commodity prices may fuel greater, or at least more persistent, inflation. Sanctions and Covid-related lockdowns in China could both lead to additional supply chain bottlenecks.

Inflation drivers. Food and energy prices continue to drive the global inflation surge (percent, median inflation rate)



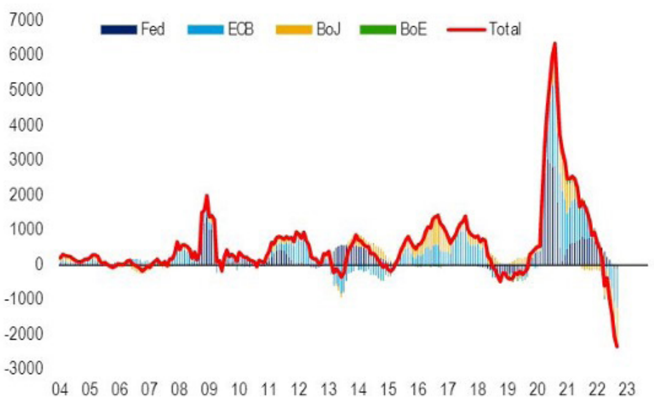
Source: IMF

STORY 3 —

The end of easy money

On 16 March, the Fed's FOMC tightened interest rates for the first time since December 2018. While Chairman Jerome Powell initially called post-vaccine inflationary pressures 'transitory', Fed officials have moved away from that stance. Through the first half of the year, they signaled their intention to implement multiple rate hikes as well as reduce the size of the Fed's balance sheet. As expected, the Fed continued to hike rates and shrunk its balance sheet by half a trillion dollars. Investors adjusted their expectations accordingly, pricing in a fast and brutal rate hiking cycle in the short-term, with potentially negative consequences on growth and thus rates later on. The European Central Bank (ECB) had no choice but to normalize monetary policy as well. The monetary policy adjustment has been global with Japan being a notable exception.

G4 Central Bank's balance sheet -$3.1 trillion in past 7 months (6 month change in G4 central banks' balance sheet in billion dollars)



Source: BofA

STORY 4 —

From rates fears to recession fears

From a macroeconomic standpoint, global GDP continued to rise above trend, but growth expectations have been revised downward throughout 2022, while now a recession in 2023 seems to be in the cards. This has led the market to move from rate fears (or bond yields weighing on equity valuations) to recession fears. Indeed, rising food and energy costs are likely to dampen consumer spending while companies may be forced to reduce hiring and expenses if rising wages and energy costs weigh on profitability. Economic indicators point to a sharp slowdown in US growth. In Europe, the energy crisis is likely to trigger a recession during the winter.

STORY 5 —

One of the worst years for US stocks since 2008 but among the best for commodities

As of the end of November, most major equity market returns are in negative territory. Developed markets' stocks are down 12.19% while the MSCI Emerging Markets index has fallen by 21.08%. Brasil's Ibovespa (which grew 7.31% in local terms) was the best performing ahead of the UK (+2.71%). The S&P 500 is down about 14.39% on a year-to-date basis. This is the worst year for stocks since 2008. In terms of style, global value (-5.60% year-to-date) is outperforming global growth (-26.68%) by a huge margin.

Commodities are the best performing asset class. At the end of November, Bloomberg's Commodity Spot Index was up 11.59%. However, performance was not positive across all commodity segments. Industrial metals ended the period in negative territory as Covid lockdowns in China weighed on industrial activity and threatened to dampen metal imports. The performance of precious metals - gold and silver - was also slightly negative.

STORY 6 —

A record drawdown for multi-asset portfolios

The "everything down market" weighed on multi-assets portfolio performance. 2022 will be remembered as one of few in history where both equities and sovereign bonds witnessed a double-digit drawdown. After a two decades bull market, bonds crashed in 2022 as the market has been progressively adjusting higher inflation and rates expectations. Looking at total return data going back to 1928 for the S&P 500, US 10-year and a 60/40 portfolio, there were only five years in which both S&P 500 and 10-Year Treasury Bond went down (1931, 1941, 1969, 2018, 2022). This year is the only year in history in which both S&P 500 and the US 10-year Treasury bond are down more than 10% each.

The last 8 times the S&P 500 was down in a calendar year, Bonds finished the year up, cushioning the blow. Very different story thus far in 2022 with Stocks and Bonds both down over 10%, something we've never seen

Year	S&P 500 Total Return (Stocks)	Bloomberg US Agg Index TR (Bonds)	60/40 Portfolio (S&P 500 / Bloomberg Agg)
1977	-7.2%	3.0%	-3.1%
1981	-4.9%	6.2%	-0.5%
1990	-3.2%	9.0%	1.7%
2000	-9.1%	11.6%	-0.8%
2001	-11.9%	8.4%	-3.7%
2002	-22.1%	10.3%	-9.2%
2008	-37.0%	5.2%	-20.1%
2018	-4.4%	0.0%	-2.6%
2022 YTD	-17.7%	-15.7%	-16.9%

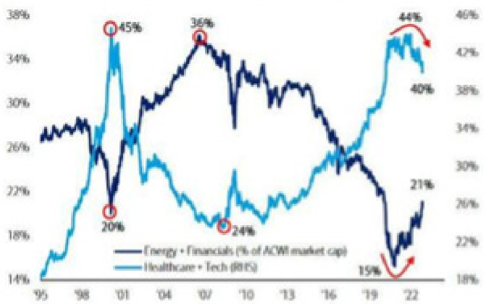
Source: Charlie Bilello

STORY 7 —

The big rotation

The old leadership, still over-owned, era of QE, has started to mean-revert. The rise in bond yields has been weighing on what is known to be "long-duration" equities. This includes mega-cap tech stocks, which were by far the biggest winners of the Quantitative-easing era. The FAANGs (Facebook, Apple, Amazon, Netflix, Google) recorded major drawdowns in 2022 due to a double-whammy effect: 1) Valuation compression (due to the rise of bond yields and lower appetite for growth stocks by global investors) and 2) A major slowdown in revenue growth as 2022 largely benefitted "re-opening" sectors while penalizing "stay-at-home" stories that faired so well during lockdown. Meanwhile, sectors benefiting from the rise of commoditiy prices and the rise in yields have been outperforming. As a consequence, the sectorial breakdown within the main equity indices has been shifting.

Secular rotation from Healthcare/Tech to Energy/Financials



Source: BofA

STORY 8 —

The King dollar

The dollar performed strongly in 2022. Expectations for faster monetary tightening in the US contributed to the currency's rally, which had gained 7.83% YTD at the end of November. Surprisingly, the Russian ruble is one of the best-performing currencies of 2022, up 22.90%. The Venezuelan bolivar (-58%) and the New Ghana Cedi (-56%) were the worst performing. Brazil's real (+7.33%) and the Mexican peso (+6.50%) appreciated on the back of strong commodity markets.

STORY 9 —

The UK crisis

2022 was annus horribilis for the UK with the death of the Queen, major political turmoil and then a financial crisis of rare intensity. During the last week of September, the pound hit an all-time low against the dollar, coming very close to parity, while sovereign bonds saw their yields reach their highest level since 2008. The scale of the crisis was such that members of the Bank of England worked through the night to save the UK's pension fund system. Indeed, the collapse of gilt bonds led to huge margin calls on UK pension funds, triggering forced sales of gilts, further fueling the decline. The following morning, the Bank of England had to announce the temporary suspension of the Quantitative Tightening and the implementation of a sovereign bond purchase program in order to curb the rise in yields. Following this announcement, UK 30-year bond yields, which had previously reached a 20-year high (>5%), fell by 0.75% to 4.3%, the largest daily fall in yields on record. Since then, the pound and gilt yields stabilized.

STORY 10 —

Another crypto winter – and a major one

The so-called "crypto winters" are part of the digital assets story and this one is indeed painful. It has been a tail of two bear markets for cryptos in 2022. The first phase took place in the first six months of the year with macro risks (i.e. the end of easy money) triggering a major re-pricing of cryptocurrencies – including bitcoin. The second phase of the correction was much more about crypto specific deleveraging and purging the excesses that took place over the last few years. After the demise of Terra Luna and the Celsius, a new scandal rocked the crypto sphere in November. FTX, the world's 2nd largest crypto exchange platform (and 1st in the US) was indeed an icon of the digital asset world. FTX has raised capital from some of the biggest names in venture capital and institutional management: Sequoia, Tiger, Blackrock, SoftBank, Singapore's sovereign wealth fund Temasek and the Ontario Teachers' Pension Fund. The FTX wallet is used by millions of users worldwide. After skyrocketing from $1 billion to $32 billion in just over 12 months, FTX lost it all in the space of 72 hours. This last scandal seriously dented investors trust towards crypto-assets, pushing the total market capitalization below $1 trillion (versus $3 trillion at the top).

Valérie Noël
Head of Trading

MACRO VIEW

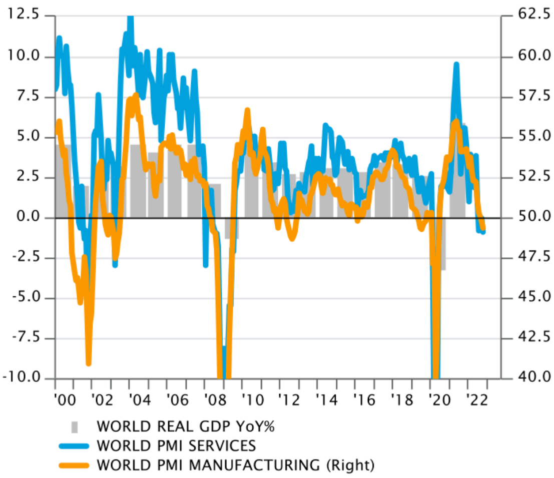
A soft landing of the global economy, with significant downside risks

As we look toward 2023, the global economic environment continues to be shaped by the aftermath of the pandemic shock. We are still in the midst of a peculiar economic cycle that started with a brutal halt in global economic activity and an unprecedented support from governments and central banks. Post-Covid reopening then unleashed a burst in demand and geopolitical developments pushed energy and commodity prices higher. As a result, inflation has surged to levels not seen in decades and has prompted central banks to raise rates in a hurry, reversing years of quantitative easing.

In 2023, global economic growth should continue to decelerate, with all large economies having to deal with negative factors. In Europe, surging energy prices and uncertainties around the consequences of the war in Ukraine have already created a shock of confidence and dragged the Eurozone and the UK on the brink of a recession. Slowing global growth also directly affects export-driven economies such as Germany or Italy, and will impact the Swiss economy despite resilient domestic demand. In the US, tighter financing conditions already undermine interest rate sensitive sectors such as real estate. Higher interest rates will weigh on US economic growth in 2023 even if the employment market remains a strong support to domestic consumption and service sector activity. China is still struggling with the pandemic, and strict anti-Covid policies could remain a headwind for growth in 2023, in a context where tighter regulations and the correction in the real estate sector are already dampening domestic demand. Japan fares no better, faced with slowing demand for its exports and softer domestic consumption due to rising inflation. Emerging Markets' fortunes differ greatly depending on the geography and structure of the economies. Eastern Europe bears the heaviest cost of the war in Ukraine, sanctions on Russia and energy supply disruption. In Asia and Latin America, economies heavily geared toward global manufacturing demand suffer from the weaker growth environment, while commodity exporters benefit from rising prices. All in all, global growth then appears likely to get weaker again and the macroeconomic environment should remain challenging in 2023.

In 2023, global economic growth should continue to decelerate, with all large economies having to deal with negative factors.

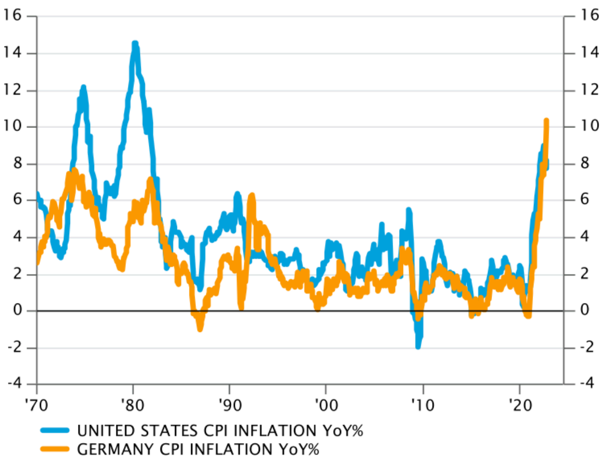
Global activity in the service & manufacturing sectors and real GDP growth



Source: Banque Syz, FactSet

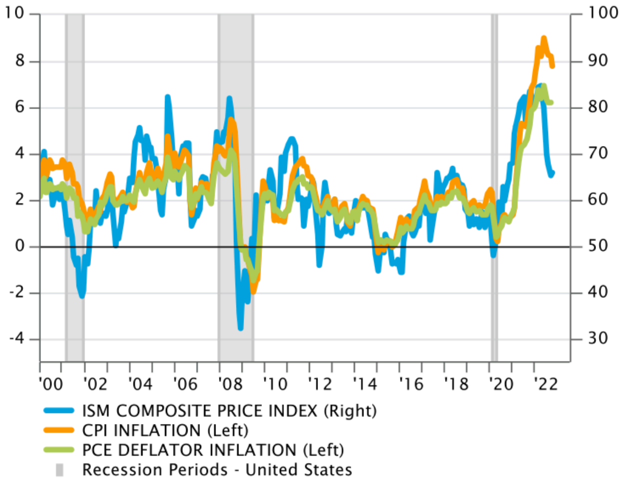
Central to economic developments in 2022, inflation will remain a key driver in 2023, for its impact on household consumption and business margins as well as for its consequences on monetary policy across large, developed economies. Inflation surged to unexpected levels in 2022 due to supply disruptions leading energy and commodity prices to rise. It also surged due to tentative signs of a wage/price upward spiral appearing in developed economies, in a context of record low unemployment. Those two powerful inflation drivers should lose steam in 2023, thanks to slower global growth and higher interest rates. At this stage, the question is no longer whether inflation will slow down from 2022 levels, but rather how fast this slowdown will take effect. Several indicators indeed point to an easing in price dynamics under the combined effect of softer final demand and supply chain normalization. However, after the inflation shock experienced this year, some factors may prove to be persistent and will likely prevent inflation rates to drop rapidly. Upward pressures on wages will remain for as long as unemployment levels remain low and give workers bargaining power in negotiations with employers. In any case, inflation is expected to remain a key driver of the macroeconomic environment in 2023. A slowdown is highly likely from 2022 levels, but the absolute level of inflation should remain higher than what has been experienced in the past decade.

Inflation rate in the United States and in Germany since 1970



Source: Banque Syz, Factset

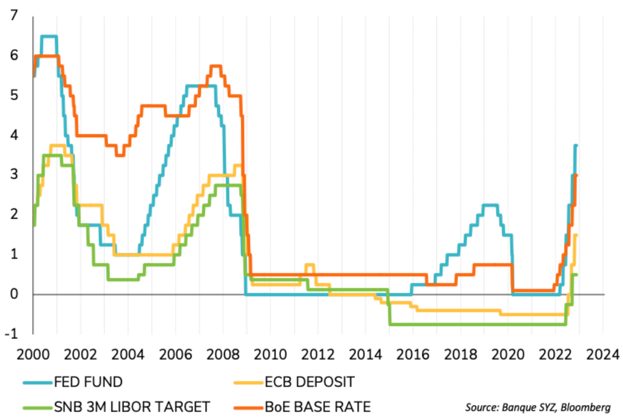
United States – Prices paid by manufacturing & service sectors and inflation rate YoY % (CPI & PCE indices)



Source: Banque Syz, Factset

In developed economies, the persistence of upward price pressures will keep the focus of central banks on making their monetary policy more restrictive, by rising interest rates and withdrawing some of the liquidities injected during the pandemic. For two decades, the low-inflation environment had allowed central banks to be very responsive, by swiftly easing financial conditions whenever downside risks to economic growth appeared. This no longer holds when inflation rates are so far off target and when expectations and underlying wage dynamics are drifting higher. In such a context, central banks have to focus on their primary mandate of "price stability". They need to tighten their policy almost regardless of any economic growth slowdown, until they can be confident that high inflation doesn't become a persistent feature.

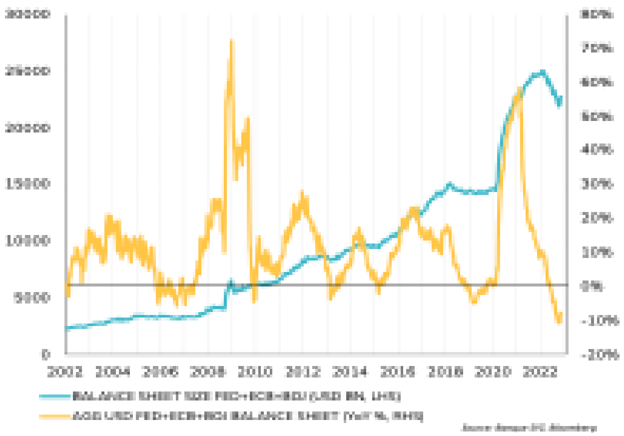
Central banks' key rates



Source: Banque Syz, Factset

This trend has already started in 2022 and some central banks are already well advanced in this process (the Fed and most Anglo-Saxon peers). The European Central Bank (ECB) is lagging behind and is still in the midst of the adjustment process along with the Swiss National Bank. The Bank of Japan stands out as the only large central bank to maintain its ultra-accommodative stance, with no intention at this stage for joining the global rate hike chorus. Except for Japan, developed central banks are expected to continue to raise short term rates and remove liquidity from the economy in 2023, while most Emerging Market central banks are close to having completed their rate hike cycle. The magnitude of future rate hikes is highly uncertain at this stage and will be dependent of developments on the inflation front. However, unless inflation were to slow down significantly in 2023, short term rates are likely to be raised toward levels that are neutral for economic activity: close to 5% in the United States, close to 3% in the Eurozone. In parallel, liquidity will be reduced as central banks work on shrinking the size of their inflated balance sheet, adding to the ongoing tightening of global financing conditions. A potential “pivot”, namely a reversal in course with rate cuts during the second half of the year, could only be contemplated if inflation were to dramatically fall and reach central banks’ targets, a scenario unlikely at this stage. In 2023, monetary policy will remain a headwind for economic activity, with a continuation of rate hikes for most developed central banks.

Central banks’ liquidity (USD and YoY%) measured by aggregated balance sheet size (Fed, ECB & BoJ)



Source: Banque Syz, Factset

The macro-economic environment is therefore expected to remain challenging in 2023, with a global economic growth slowdown, lingering inflationary pressures, and tighter financing conditions. However, before getting overly depressed, one has to bear in mind that those developments are already largely priced in by financial markets. Lower global growth, including a “winter recession” in Europe and a US economy running out of steam, appear to be the consensual view for the coming year. Indeed, economic data surprises have been positive in all main regions since the end of the summer. Even if weaker in general, those data have proved to be “less weak” than economists’ forecasts, a sign that the ongoing deterioration in growth is, so far, already widely accounted for. A significant decline in inflation rates is also already discounted for 2023, as reflected by the low level of survey and market-based inflation expectations. And a continuation of rate hikes from major central banks is also clearly priced in when looking at forward market interest rates.

Around this scenario, we identify two types of risks that could lead to an unexpected additional deterioration of the macroeconomic backdrop next year. Firstly, “conventional downside risks” at this stage of the cycle cannot be neglected, even if this economic cycle is born out of a very atypical shock and policy response. The ongoing energy crisis in Europe, so far mitigated by mild temperatures throughout the autumn, remains a strong headwind that has already severely hit business and households’ sentiment. Europe is at the mercy of cold temperatures and potential renewed upward pressures on energy prices that may impact economic activity more heavily and trigger a deeper and/or longer recession than currently expected. In the US, the strong tightening in financing conditions, already heavily impacting rate-sensitive sectors such as real estate, will be fully felt by the rest of the economy only in the course of next year and might trigger a proper recession. The brutal rise in interest rates also raises the risk of financial instability and of a “systemic event” derailing the expected global growth trajectory. In a nutshell, the risk of a weaker-than-expected growth environment is significant in this context of higher rates, strong US dollar and declining liquidities. And energy prices remain a sword of Damocles hanging over the outlook, especially for Europe.

“Unconventional downside risks”, resulting from the very peculiar nature of this economic cycle, also threaten the 2023 outlook. Inflation could potentially remain at an elevated level instead of gradually slowing down, either for endogenous reasons (resilient final demand) or from exogenous factors (additional increase in energy and commodity prices, geopolitical and trade tensions…). In both cases, persisting inflationary pressures would likely weigh on consumption and economic activity. They would also force central banks to raise their key rates to actual restrictive levels, beyond the peak currently expected for 2023. Such forced monetary policy tightening in the midst of an ongoing economic slowdown would likely further heighten the risks of a “growth accident” or of a systemic event, leading the macro-economic environment to become even more challenging next year. Lastly, the recent rise of Covid cases in China shows that the world is not completely out of the pandemic yet, and a new outbreak could strike yet another blow to an already weakening global growth rate.

We believe that there is a path between the risk of a sharp growth slowdown and the risk of inflation remaining too high. Central bankers will have to find the right balance and tighten monetary policy sufficiently to dampen inflationary pressures, without triggering an abrupt growth slowdown or systemic financial instability by overtightening. Similarly, governments will have to find the right balance with some fiscal support to mitigate the impact of rising prices on households’ purchasing power, without unduly fueling inflationary pressures or worsening further public finances already stretched by the massive response to the Covid pandemic. The macroeconomic trajectory for 2023 is at stake and much depends on the ability of policy makers to be reactive to the evolution of economic conditions. With their credibility and reelection prospects also at stake, the incentive is strong for them to find the right balance, unlike the “whatever it takes” kind of responses that had become the norm.

We also do not want to rule out potential positive surprises that could help to improve the environment next year, even if they are more likely to come from outside the strictly economic sphere: an easing in geopolitical and trade tensions (Europe/Russia, US/China in particular) could help dampen global inflationary pressures and bring some relief to central banks, and potentially stimulate global trade and economic growth. A mild winter in Europe could help to soften the impact of high energy prices and potential restrictions on economic activity. A reopening of the Chinese economy, with receding Covid-related restrictions and a less interventionist government, would also have a significant impact on global economic growth, even if it is possibly at the cost of higher energy and commodity prices.

To sum up, the economic environment will likely remain challenging in 2023 as economic growth slows down while inflation remains elevated and central banks continue to raise rates. However, we do not expect that the macro-economic situation will deteriorate much more than what is already expected, leaning towards a scenario of an economic “soft landing” after the turbulences of the past three years. Decision makers may be able to adjust monetary and fiscal policies and manage the highly unusual combination of downside risks to growth and upside risks on inflation. Still, risks around this central scenario are mostly tilted to the downside for a global economy already weakened by the developments of this year.

Adrien Pichoud
Chief Economist

PORTFOLIO CONSTRUCTION

Asset allocation

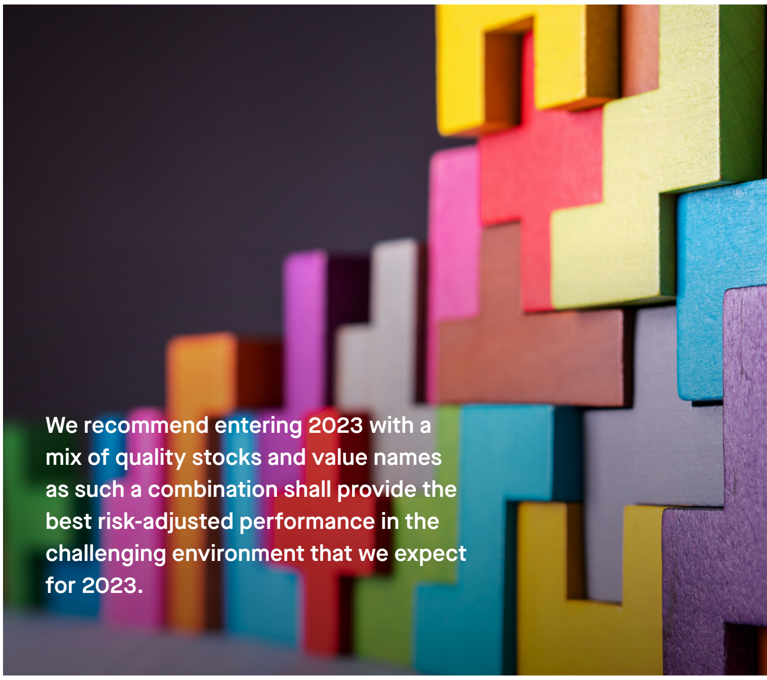
Developments in 2022 have significantly changed the backdrop for portfolio construction, with the return of positive yields for cash.

Aside of the fact that both equities and bonds posted double-digit losses, one of the key points of 2022 is the sharp rise in nominal interest rates for most major currencies, especially on the short end of the curve. For instance, US dollar cash is currently paying 4.5% (vs 1% at the end of 2021), Euro cash rate is 0.75% vs -0.75% and even in CHF the cash rate is (slightly) positive. In the short-term bond's universe, opportunities are extremely attractive, without a need to venture outside the "investment grade" category. Moreover, the major yield curves are inverted, distorting the investment opportunity set and having strong implications for portfolio construction.

In terms of portfolio construction, interest rates on cash have strong implications: they will push all investors to re-assess the level of required return of all risky asset classes (bonds and equities in particular). Indeed, investors' decision to take a risk will be made in contrast to a "safe" cash rate that is more attractive than it has been for almost 15 years.

In line with our macro-outlook, we remain rather cautious on equities in our asset allocation, as markets continue to face many challenges. In particular, we are closely monitoring the evolution of earnings growth momentum and the magnitude of the expected US recession in the first half of the year. We recommend entering 2023 with a mix of quality stocks and value names. Such a combination shall provide the best risk-adjusted performance in the challenging environment that we expect for 2023.

For the bond allocation, we enter 2023 with a positive stance on credit and a cautious stance on duration risk. We expect to keep our large exposure to short-term quality bonds that we have been building up since May 2022. Given the current cash rates, we expect to have more (invested) cash in our managed portfolio, combined with additional exposure to short-term bonds (2-3 years) that will return yields of around 5% in USD and 3% in EUR.



In terms of decorrelated positions, our combination of a large exposure to real assets, commodities and hedge funds has proven effective, as these are among the few asset classes that had a positive performance in 2022. We expect the financial environment to be more supportive for hedge funds, which is why we have increased our exposure to uncorrelated strategies that should deliver cash +3% return in 2023.

Luc Filip

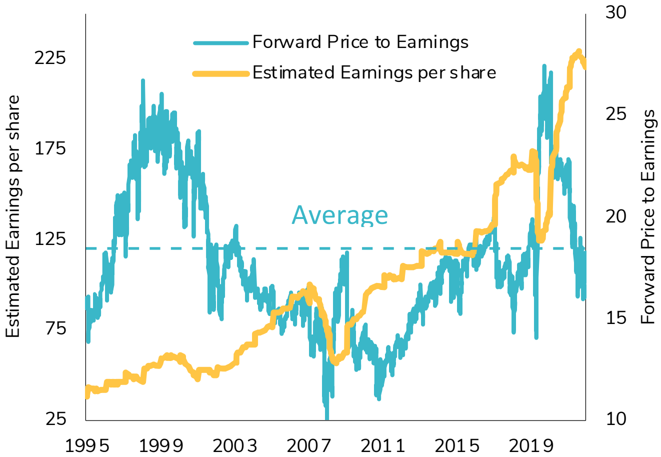
Head of Discretionary Portfolio Management

A year of two halves, remain defensive for now

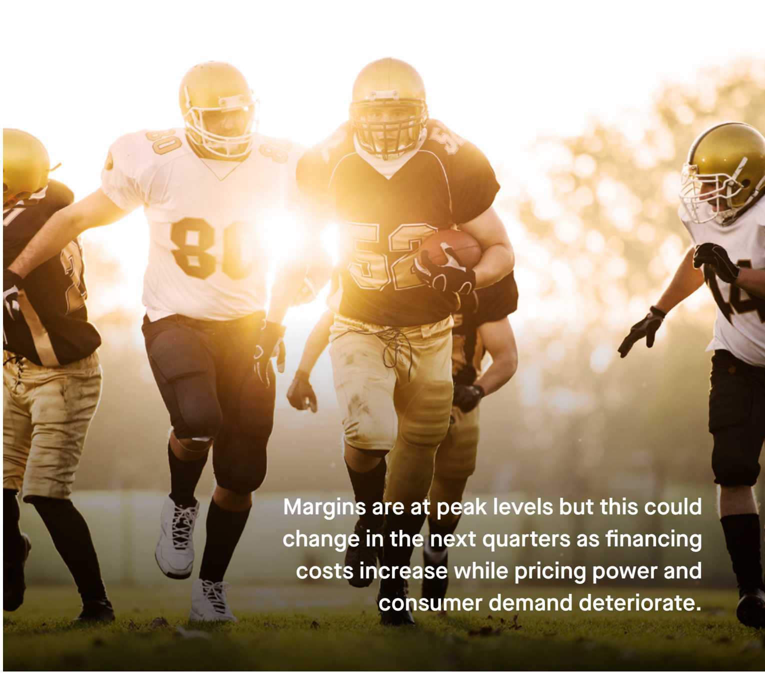
2022 will be remembered as one of few in history where both equities and sovereign bonds witnessed a double-digit drawdown. Over USD 20 trillion of value were wiped out from global equity markets in the first nine months. This will have a lasting psychological effect on retail investors, leading many to think twice before buying shares.

This is particularly true as more attractive yields in bond markets are making them more appealing than before, something unseen in the last decade. The 2022 equity drawdown is in large part a result of higher interest rates that compressed multiples (Price to Earnings) paid for companies (blue line in the graphic). The starting point was elevated (expensive multiples), so this decrease brought back valuations to fair, but not cheap, levels. Despite a risk of further multiple compression caused by a severe recession (not our main scenario), we believe the big threat to equities arises less from valuations than from earnings (orange line in the graphic). So far, most companies have not struggled with higher financing costs. They also have been able to pass through higher input costs and have seen resilience from consumers. As such, margins are at peak levels but this could change in the next quarters as financing costs increase while pricing power and consumer demand deteriorate. In a mild recession, earnings should decline by around -10%. These risks need to be counterbalanced with potential good news that would be very positive for markets. For instance, an end to the conflict in Ukraine, a reopening in China or a marked slowdown in inflation would be a relief for markets.

U.S. market fundamentals and valuation



Source: Bloomberg as of 30.11.2022



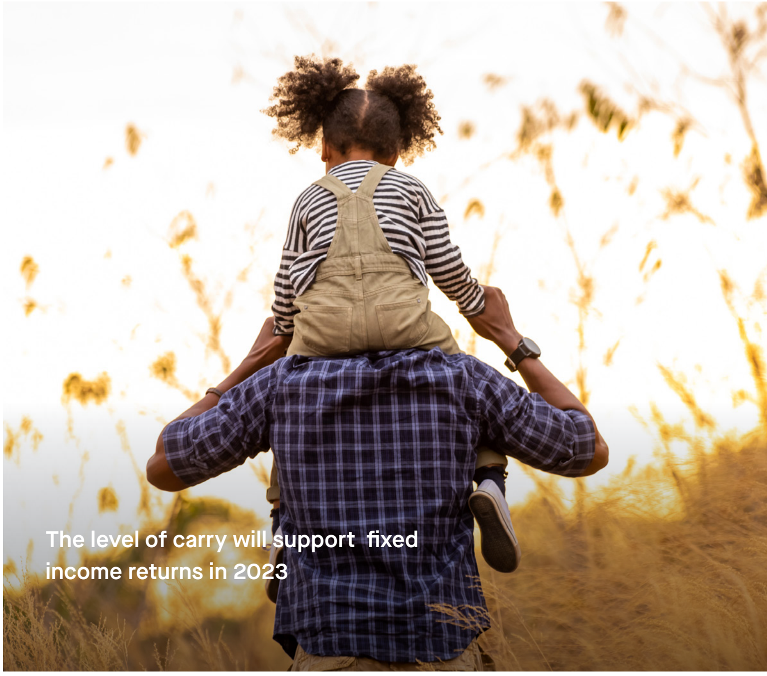
With this scenario in mind, we choose to remain defensively positioned for the time being. We prefer companies with durable pricing power, stable margins and products/services that cannot easily be forgone or replaced. We find these companies in sectors such as healthcare and consumer staples. We also remain positive on the energy sector. Even in the case of a recession, where there is usually a decrease in demand, structural imbalances stemming from underinvestments in the last decade are so pronounced that oil prices should remain elevated.

Besides our main scenario, we also want to consider alternative ones. It is unclear when markets will bottom, but they will probably remain choppy in the first half of the year until there is more clarity on central banks' actions. In addition, markets will be gauging to which extent the economy has been impacted by higher rates. But if one of the positive surprises mentioned above materialises, 2023 should offer very attractive entry points for valuable companies trading cheaply due to their geographical location (e.g. China) or due to their sector (e.g. Technology).

Saïd Tazi
Head of Equities

Carry the opportunity!

We started 2022 without a safety net (carry), with rates close to zero or in negative territory. However, the markets had to face a double inflationary shock caused by the reopening of the world economy (except for China) and the war in Ukraine. This explosive inflation cocktail triggered a sharp and quick monetary tightening cycle and the end of zero/negative interest rate policies around the world. In response, the markets strongly revalued this new inflation and monetary policy regime by sending the 3-month US Treasury note to nearly 5%, up from 0% a year ago, bringing about the biggest US yield curve inversion ever. With double-digit losses for all fixed income segments except leveraged loans, 2022 is the worst year ever for the fixed income asset class. Nevertheless, the 2023 outlook is much brighter than it has been in the last decade, thanks to one crucial element: carry.



We are more positive on the fixed income asset class for 2023 based on its attractiveness in absolute and relative terms.

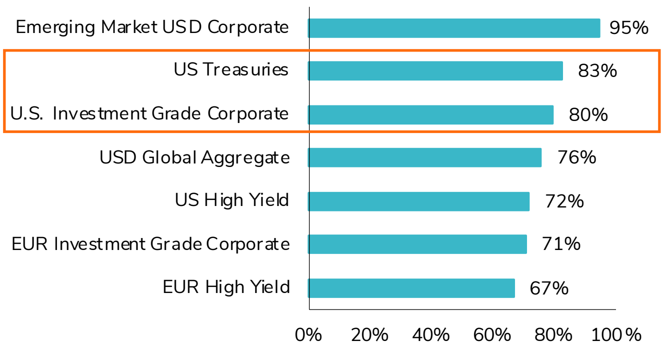
Indeed, the yield on US investment grade bonds is now at its highest level in a decade, and is higher than the earnings yield on the S&P 500 Index (chart 1).

Chart 1 - U.S. Investment Grade corporate bonds yield vs S&P500 earnings yield

Source: Bloomberg

In absolute terms, fixed income yields are entering a very attractive zone relative to history. The percentile of yields of the major fixed income indices is now close to 80% on average over the past 20 years (chart 2). This means that only 20% of the yields observed since the beginning of this century were higher than the current ones.

Chart 2 - Percentage of yields of fixed income indices since 2000 that are lower than current ones



Source: Bloomberg

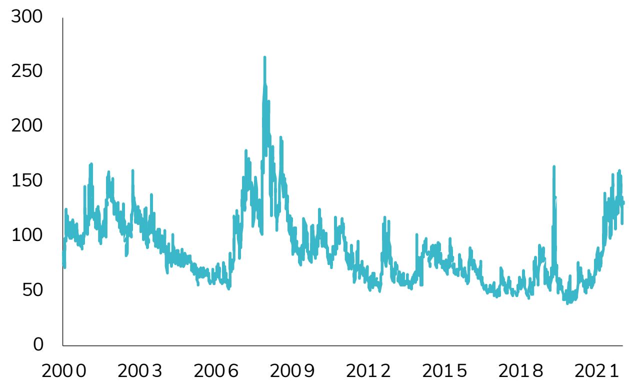
We turn selectively positive on government bonds. We really like the front end of the yield curve as it offers decent carry and low rate sensitivity, whereas we believe the long end of the US yield curve is less attractive. Indeed, the recent yield curve inversion (chart 3) is putting any investment in bonds with a maturity superior to 20 years at risk.

Chart 3 - Gap between the 30-year and the 3-month U.S. Treasury yield

Source: Bloomberg

We also need lower rate volatility (chart 4). In 2022, rate volatility was extremely high by historical standards, triggering significant capital outflows and further uncertainty.

Chart 4 - Volatility index (MOVE) in U.S. interest rates



Source: Bloomberg

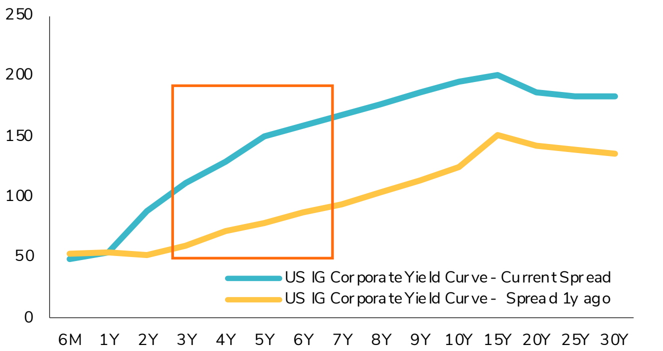
Finally, we must first be convinced that inflationary pressure will calm down and quickly return to central banks' target levels before contemplating long-term maturity bonds. At this point, nothing clearly signals us to invest in long-term bonds.

In Europe, the potential for further rate hikes is still present, but the terminal rate should be much lower than in the U.S. However, the European Central Bank is still lagging and is expected to tighten monetary policy by raising rates and ending its quantitative easing.

In this context, we favor US government bonds over European ones.

On the credit side, we continue to like short-term maturity US investment grade corporate bonds and are becoming positive on the intermediate segment by taking advantage of the steepness of the credit spread curve (chart 5).

Chart 5 - US Investment Grade Corporate credit spreads



Source: Bloomberg

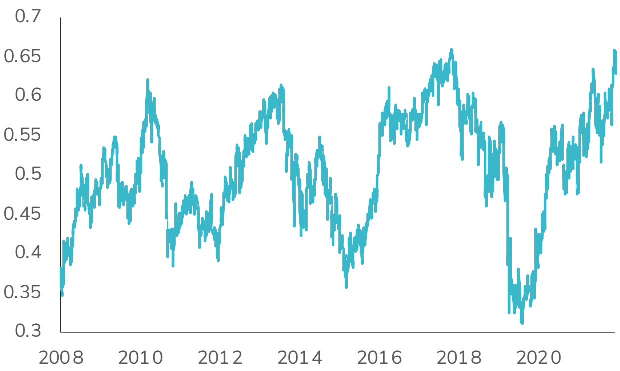
In Europe, the absolute level of rates does not protect investors as it does in the United States, but the European credit market has suffered more (widening of credit spreads) and the spread between the swap curve (the benchmark that companies use to refinance themselves) and government bonds is at extreme levels (Figure 6). These two elements argue in favor of allocating some investments to quality European corporate bonds.

Chart 6 - Differential between 10-year German and EUR Swap yields

Source: Bloomberg

We remain very selective in the high yield segment and recommend investing only in very short maturities (2 years maximum), in companies with no major repayments to come and with very good visibility on their cash flows. The high yield segment should suffer from the likely rise in default rates and the low valuation compared to high quality paper (chart 7). On the other hand, supply should continue to remain limited, as there is no refinancing pressure before 2025.

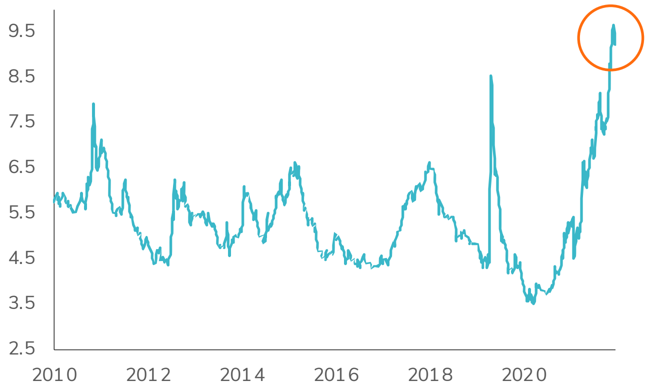
Chart 7 - Ratio of yields between U.S. investment-grade and high yield bonds



Source: Bloomberg

In Emerging Markets (EM), we favor short-term bonds because of the fundamentals and valuation of companies. Indeed, the fundamentals of EM companies have never been better (low debt, low dollar exposure, full benefit of the commodity boom), which gives visibility over one or two years. In addition, the valuation of the segment is now in attractive territory (chart 8). The average yield on emerging market corporate bonds is currently above the Covid crisis level, due to isolated cases such as the war in Ukraine and the implosion of the Chinese real estate sector. This carry is high enough in our view to protect us from short-term volatility.

Chart 8 - Average yield of Emerging Market Corporate bonds index



Source: Bloomberg

In conclusion, we believe the fixed income asset class will start the year at a level of value not seen in a long time, backed by high carry. We believe it is time to selectively add structural exposure to fixed income. A barbell approach consisting of high-quality short to intermediate maturity paper and very short-term (risk-mitigating) emerging market and high-yield bonds could be the ideal combination to generate attractive returns in 2023.

Gaël Fichan
Portfolio Manager & Fixed Income Lead

Fabrice Gorin
Deputy Head of Discretionary Portfolio Management

PRIVATE MARKETS

2023: a good vintage?

Last year in the same annual outlook, we were debating if private markets were a derivative of public markets or a true alternative. Coming to the end of a real test year, the response may be less clear cut than one may think.

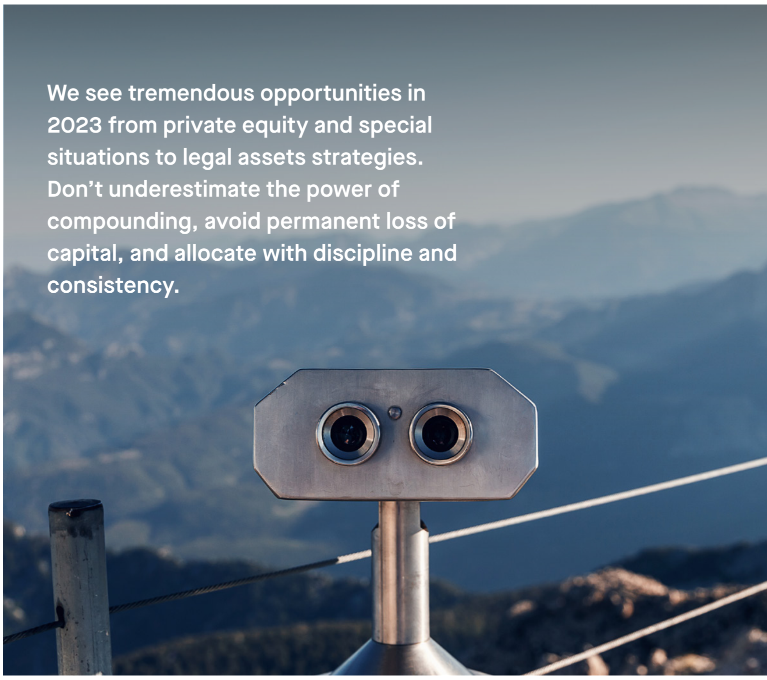
On one hand, the performance of private equity portfolio has been very resilient in 2022. High growth strategies have been more impacted as a severe slowdown in IPO activity together with an increasing discount rate affected the valuation of such long dated cash flows.

On the other hand, it is clear that there is a natural time lag between private assets and public markets due to the absence of mark-to-market on the former. Most private equity funds have kept their carrying valuation unchanged, regardless of the current macro gloom. This decoupling may at times be justified, but more likely temporary with this time-lag effect eventually coming to end in 2023.

So where do we see the market going in 2023? Given the sharp decrease in distributions in 2022 (with no clear signs of improvement in 2023), private equity investors are finding themselves with lower levels of cash. In addition, allocators find themselves overexposed to private market strategies due to the "denominator effect" (i.e. because of their relative good performance in 2022, private equity allocations now represent a larger part of portfolios vs. equity and bonds). Rebalancing portfolios is not an easy task as the bid-ask spread on the secondary market is wide (sellers don't want to take a hit on strong NAVs, while buyers are pricing a recession and applying comparable public multiples). In this environment of slower distributions, fundraising has slowed down but private equity activity remains high on the back of high-dry powder from previous vintages.

While many associate volatility with risk, we tend to consider it as a source of opportunities. Shortage of capital provides a good investing environment as those holding cash can be "price-setter" instead of "price-receiver". Being long-term investors, we have to invest, hold and manage our positions across market cycles, up or down. Discipline and consistency remain paramount to avoid vintage risk and to take advantage of the long-term superior returns on offer in private markets.

At Syz Capital, we still focus on companies and business models that benefit from a unique positioning in their niche markets. We like mission-critical businesses with pricing power, allowing us to pass inflation forward and often even increase our margins. We like companies facing ownership transitions and looking for a financial and operating partner to help them consolidate their market leading position, in environments where smaller and weaker players struggle.



We see tremendous opportunities in 2023 from private equity and special situations to legal assets strategies. Don't underestimate the power of compounding, avoid permanent loss of capital, and allocate with discipline and consistency.

"Tech is not dead" and is increasingly attractive now that valuations in this sector seem to have reset. While historically cautious on venture, we take a more constructive stance as "when the tide goes out, we can see who was swimming naked". Historically some of the best companies have been created in or emerged out of a recession. Finally, we like and continue to invest in uncorrelated assets such as the ones whose value derive from legal decisions, such as litigation financing or law firm lending. Not only are they great diversifier, but they provide very attractive risk-adjusted returns on a standalone basis and are completely decorrelated from the markets.

We encourage investors to take a long-term view and consider the current uncertain economic environment to allocate part of their capital to quality assets and well managed private companies with strong and profitable business models. History tells us that recession years are generally good vintages, but that being selective and diligent is key. We see tremendous opportunities in 2023 from private equity and special situations to legal assets strategies. Don't underestimate the power of compounding, avoid permanent loss of capital, and allocate with discipline and consistency.

Olivier Maurice
Managing Partner, Syz Capital

Promising environment for hedge fund strategies

The world has changed, and so has the financial landscape. After years of negative or zero interest rates at best and large liquidity inflows by central banks, when corporate growth was made easy by cheap capital, the tides have finally turned.

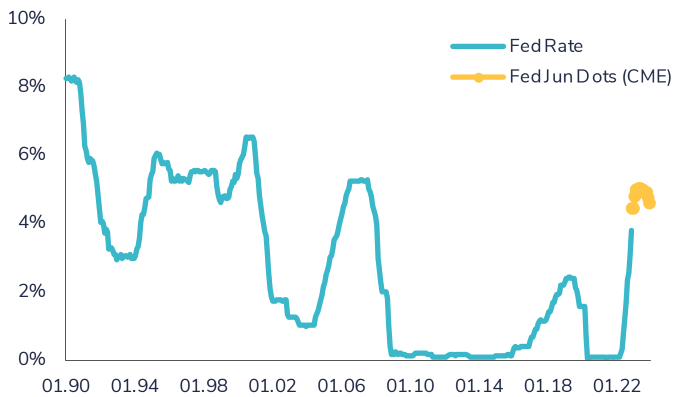
Persistent inflation, higher interest rates, geopolitical tension and liquidity reduction are bringing a higher range of volatility and dispersion which, for quite some time now, hedge funds had been waiting for. Concerning the dispersion of equity markets, we expect that it will soon pick up as the next earnings seasons will be impacted by the global growth slowdown.

Historically, hedge funds have also outperformed in higher rate environments. As many strategies use derivatives, funds own a large proportion of cash in their portfolio (up to 90%) which brings higher remuneration. This is why hedge funds are often called a “cash +” asset.

In 2023, many strategies will benefit from this new environment: macro, equity/credit market neutral, volatility arbitrage, fixed income arbitrage, which have already brought positive performance in 2022 for our uncorrelated portfolios.

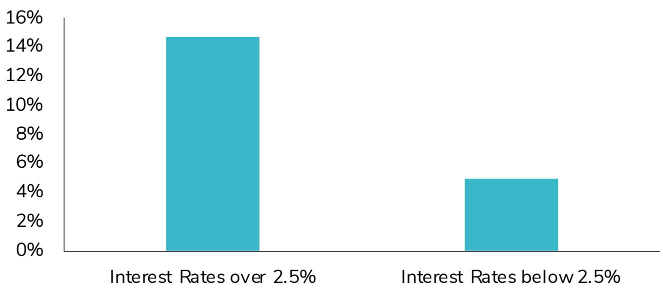
With investors also questioning the diversification benefits of the equity-bond pair, alternative investments are more than ever a way to diversify portfolios.

Higher performance in a higher rates environment



Source: FRED

HF Annualized returns in high vs low interest rates



Source: Bloomberg

Long/short opportunities in a stressed credit market

For the last 15 years, extreme monetary easing from global central banks and increasing fiscal stimulus have fueled a rally in credit markets. In tandem, this created a very difficult environment for alpha creation for long/short managers.

After one of the worst years for alpha creation in 2021 for this strategy, the central banks’ decisions to reduce liquidity and to increase rates have once again brought back dispersion to the credit market, separating strong companies from weaker ones.

The high yield market will be first to see the effects of higher rates as companies will have to refinance at significantly higher levels (2024 and 2025 will be the peak of refinancing). These credits are lower quality and generally have a shorter duration than their investment grade counterparts. We can expect to see weaker companies struggle to complete these new financing rounds which will be bringing a raft of new opportunities on the short side for hedge fund managers.

The credit market is currently experiencing an unprecedented correction and is offering great opportunities on the long side through short duration bonds.

For 2023, we therefore favor managers with a strong skill for shorting and the ability to select long opportunities in the current stressed market. The Eurozone should be interesting as the market is less efficient than the US, with more segmentation due to the number of markets. Credit “market neutral” quant strategies would also benefit from higher volatility and dispersion. Additionally the barrier to entry is high for this strategy due to its inherent complexity.

Cédric Vuignier
Head of Managed Funds, Syz Capital

INVESTMENT THEMES

How to defy the medium-term uncertainties?

2022 has certainly been the worst year ever for traditional portfolios (aka 60/40 portfolios) as both equity and bonds plunged due to the deteriorating macro and geopolitical environments, the rise in inflation and the subsequent tightening of global monetary policies.

Looking forward in 2023 and beyond, some investment themes and approaches seem attractive. Let's explore a few of them.

From TINA (There Is No Alternative) to TIC (There Is Carry). From a low interest rate environment where equity and growth are the only viable alternative, to an environment where yields are back in fashion thanks to higher interest rates and credit spreads. Rates are now expected to gradually stabilize in 2023, as the bulk of the adjustment triggered by inflation and central banks has probably already been factored in. Inflation is now expected to gradually slow down and ease its pressure on central banks for rate catchup; this creates attractive levels to purchase high quality, shorter-maturity investment grade corporate bonds.

The new FAANGs? The years of sluggish growth, low inflation and monetary easing have benefited growth stocks, especially the digital giants - the so-called FAANGs. But then 2022 marked the end of monetary easing and the geopolitical conflicts revealed the weaknesses of a bipolar world where the old economy has been underinvested, especially in the commodity sector. So who are they?

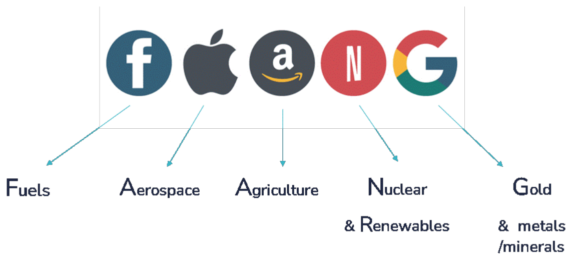
Fuel. Lack of capital expenditures has caused a structural imbalance in oil and gas supply.

Aerospace. Increased monetary spending by NATO countries. Even Germany is re-arming itself by increasing its budget by 100 billion euros.

Agriculture. The war in Ukraine revealed the need to increase efficiency and produce locally. Ukraine is the fifth exporter of wheat.

Nuclear. To reduce dependance on fossil fuels.

Gold and metals. A safe heaven in times of geopolitical tensions, and inflation is expected to be structurally higher due to deglobalization and decarbonization efforts.



The energy transition will take years. As a result, commodities still have some fuel in the tank. We are positive on the oil & gas sector which we think will remain at elevated levels even though a potential global growth slowdown could temporarily suppress demand and weigh on prices. The main issue for the sector seems to be a lack of sustainable supply due to decades of underinvestments by large oil companies which preferred to focus on the transition to renewable energy production.

For the near future, we expect no excess supply due to output cuts from OPEC and the implementation of new import sanctions on Russian oil as of 5 December. Oil prices should also continue to rise thanks to China's improving outlook; the country recently announced a relaxation of its zero-Covid approach and a plan to support its real-estate sector.

We nevertheless acknowledge that the energy transition will eventually impair oil demand growth and oil price, but we believe this process will take several decades and, during the ramp up phase for renewable energies, the world will remain heavily dependent on fossil fuels.

"Chindia" can't be ignored. China and India are growing fast and account for one-third of the global population. In 2050, their GDP is expected to be double that of the U.S. Still, their market capitalization is approximately one third of US market capitalization. If at the moment China looks un-investable by many institutional investors, the current regulation upgrade held under the "common prosperity" banner should facilitate, in the long term, the transition from an emerging to a developed economy. As for India, good economic fundamentals and the growing middle class favor the emergence of a local consumer market.

Hedge funds + Private Equity = diversification new age. It is interesting to note that, according to a BofA study, a 25/25/25/25 portfolio (stocks/bonds/commodities/cash) would have fared much better in 2022. Nevertheless, we believe that diversification could also be achieved through alternative investments such as hedge funds or private equity, which usually have low correlations with the returns of the stock and the bond markets and thus help a portfolio to mitigate both market and cyclical risks.

Active management, the return. Finally, in 2022, we have seen that the deteriorating economic cycle has created a very challenging investment environment that will probably remain uncertain for a while. Interest rates will likely remain elevated for some time and may even continue to rise if inflation does not slow down rapidly enough. We thus believe that the current conditions call for the knowledge and experience of active investment managers, as opposed to the use of passive investments. Passive investments greatly benefited from the low interest rate environment and subsequent bull market of the past 13 years, which lent wings to often profitless, speculative "concept" stocks. Now that volatility is increasing and that global markets are finally more adequately pricing risk and money, investors need the clear fundamental framework of an active manager who constantly adjusts selection and exposure to reflect the evolution of prevailing risks. We therefore expect active managers to be better drivers of investors' returns going forward.

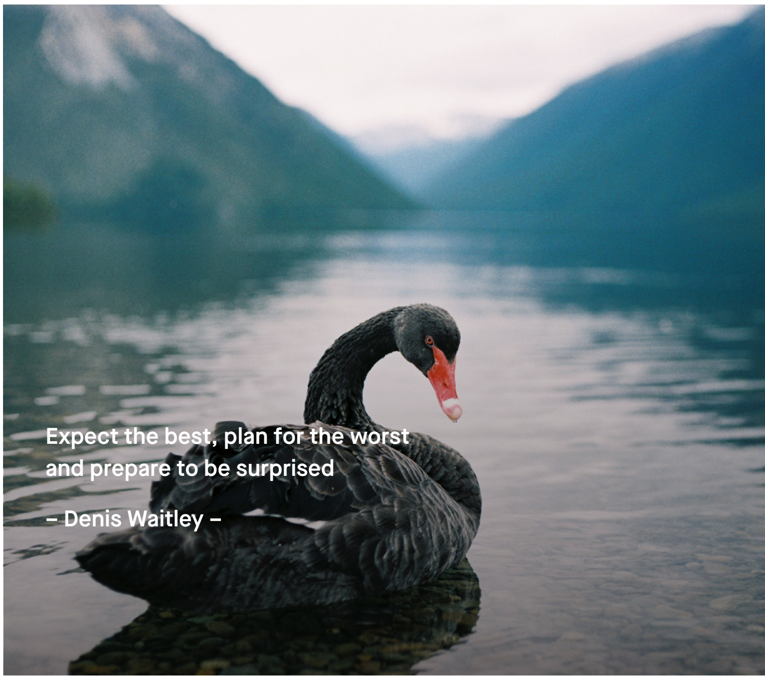
Antoine Denis
Head of Advisory

THINKING OUTSIDE THE BOX

Ten Potential Surprises for 2023

Below are the top 10 events and surprises that could mark the financial markets and the global economy in the New Year.

We believe that these events and surprises are vanilla ones. Nevertheless, we also try to assess the probability of occurrence (high, medium, low) for each one.



SURPRISE #1 —

US Inflation drops below 4%

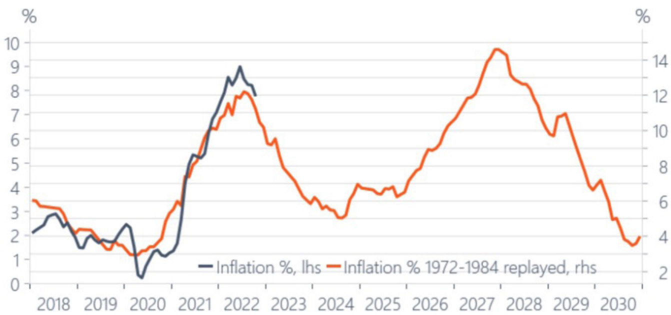
[Probability: Medium]

The surge of inflation to almost double-digit levels was most likely the biggest macro-economic surprise in 2022. As we enter into a New Year, inflation might well surprise investors again – but this time positively instead.

Inflation is the rate at which prices change on a year-on-year basis. As the base effect will become more favorable, and due to a sharper than expected drop in goods prices, US inflation might come back down to surprisingly low levels.

However, this drop might prove to be short-lived. As in the 70s (see chart below), structural factors and a Fed policy mistake (aka premature pause in the tightening cycle) could prompt a new inflationary wave in the years that follow.

Inflation today vs. 1970s



Source: Bloomberg

SURPRISE #2 —

QE for the markets, rate hikes for everyone else

[Probability: High]

While global economic growth and inflation might both surprise on the downside, the Fed could initially be reluctant to pause its rate hike cycle. In other words, they might over-tighten. Consequently, equity and bond volatility could jump in the first half of the year, with the risk of triggering financial

For instance, G7 countries could face a buyer's strike for their claims, as international investors might be reluctant to get low or negative real rates for bonds issued by highly indebted countries. Similar to the UK, the Fed (and the ECB) would initially refuse to stop hiking. But with the spike in long-term bond yields, they would have no other choice than to re-launch QE (Quantitative Easing), targeting the long-end of the curve. In other words, they would be resorting to QE to save financial markets while hiking rates for everyone else.

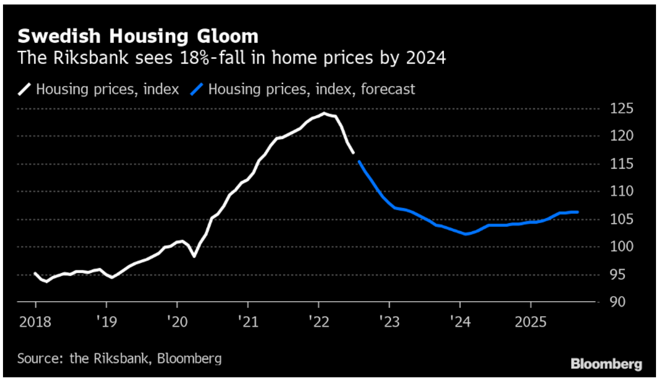
SURPRISE #3 —

A housing crash of epic proportions

[Probability: High]

2022 saw the burst of several bubbles (bonds, equities, cryptos). In 2023, real estate could be the last shoe to drop. Indeed, the tightening of the monetary cycle is hitting the interest-rate sensitive part of the economy the most. Countries with a high percentage of variable rates mortgages could endure a double-digit decline of housing prices. Sweden, a country where nearly 70% of the mortgages have variable rates, could face a double-digit decline in housing prices according to the Riskbank.

Swedish housing gloom



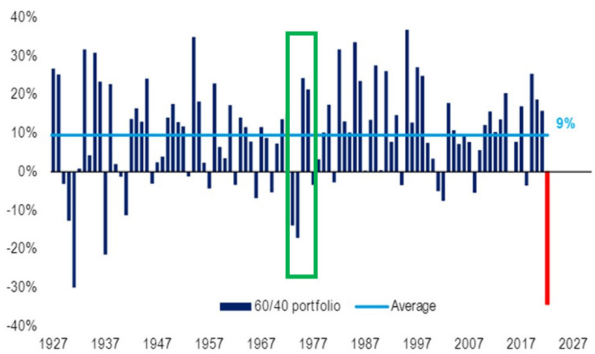
Source: Bloomberg

SURPRISE #4 —

A (temporary) come-back of the 60/40 [Probability: Medium]

2022 was an "annus-horribilis" for the 60/40 (stocks-bonds) portfolio, as both equity and fixed income markets strongly correlated on the downside. 2023 could see a turnaround in both markets. After another volatile semester (1H 2023), a pause by the Fed and attractive valuations could lead investors to come back to equity and bond markets. Multi-assets portfolios would then enjoy a massive rally and record one of their best years ever. This would be similar to what happened in the 70s (see red box in the chart below).

In 2022, the "60/40" portfolio annualized return is the worst in the past 100 years



Source: BofA Global Research

SURPRISE #5 —

China (sanitary) pivot... or not [Probability: High]

China's zero-covid policy has had a disastrous impact on growth in 2022 and has triggered a wave of protests. Beijing is now at a tipping point, which could lead to two tail risk outcomes:

Positive outcome: Beijing finally decides to change its economic and monetary policy. Zero-covid restrictions get progressively lifted. Regulations for technology, gaming and education sectors become more supportive. Significant fiscal and monetary stimuli are injected into the economy. Relationship with Washington progressively improves. On the back of these tailwinds, Chinese equities become the best performing asset in 2023 and the yuan rallies.

Negative outcome: China experiences protests reminiscent of Tiananmen. Human casualties rise to the point where the West decides to apply sanctions and cut some ties with China. The global supply chain is severely disrupted and leads to upward pressure on inflation and downward pressure on growth. The Yuan crashes and stems a wave of competitive devaluation in China. Risk assets tumble globally.

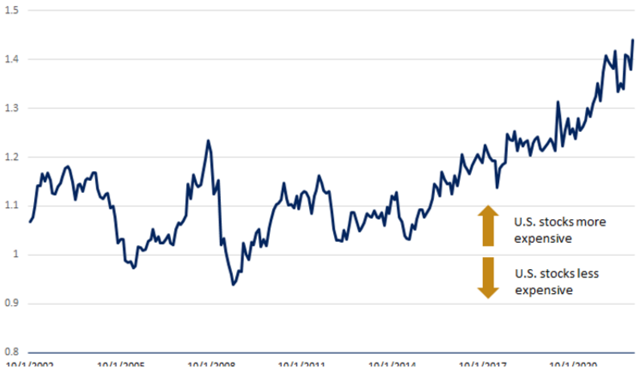
SURPRISE #6 —

Dollar drops; Emerging Markets and European assets outperform [Probability: Medium]

2022 has again been favorable to US assets (dollar, US stocks). At the time of our writing, US now accounts for 70% of the MSCI World and non-US assets remain massively under-represented in global portfolios.

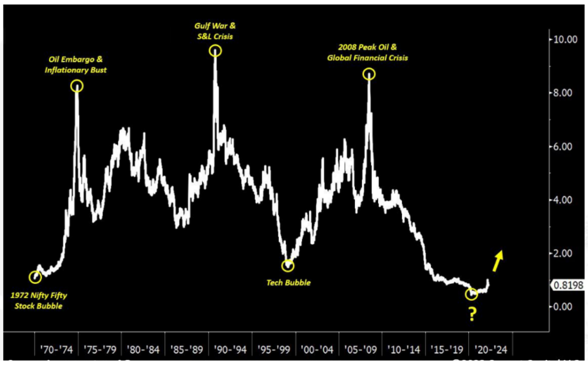
In the case of a favorable macro-economic and liquidity scenario (the Fed pausing, China re-opening and the global economy avoiding a deep recession), the dollar could end its two-year bull market while the Euro, the Yen and Emerging Market currencies would enjoy a spectacular rally. For once, European, UK and Emerging Market assets would outperform the US.

US stocks are relatively more expensive than international equities



Source: Edward Jones

Commodities to equity ratio



Source: Crescat Capital, Bloomberg

SURPRISE #7 —

Iraq collapse in H2 leads to another spike in oil prices [Probability: Low]

The war in Ukraine is entering stasis. The support for war is ebbing on all sides and the market is slowly moving into indifference (although the human cost of the war must never be dismissed). But the real danger to oil supply in 2023 likely won't come from Russia's war in Ukraine, but Iraq's instability. A big geopolitical surprise could be if Iran and Saudi Arabia enter into conflict over Iraq. That is where oil supply loss would happen. With dramatic consequences on oil prices.

SURPRISE #8 —

Commodities are the best asset class again. Gold shines [Probability: High]

While commodities are the best performing asset class in 2022, fund flows have been negative and it remains massively underrepresented in global asset portfolios.

With a potential spike in oil prices in the second half of the year and the drop of the dollar, commodities could record another spectacular year as asset allocators finally decide to include commodities in global portfolios. Precious metals (Gold, Silver) would surge on the back of a weakening dollar and declining real interest rates (due to the rise of long-term inflation expectations). Commodities' relative performance against equities tend to last several years in both directions (up and down). We might be at the start of a secular upward trend for commodities' relative performance.

SURPRISE #9 —

Bitcoin hits $40k [Probability: Medium]

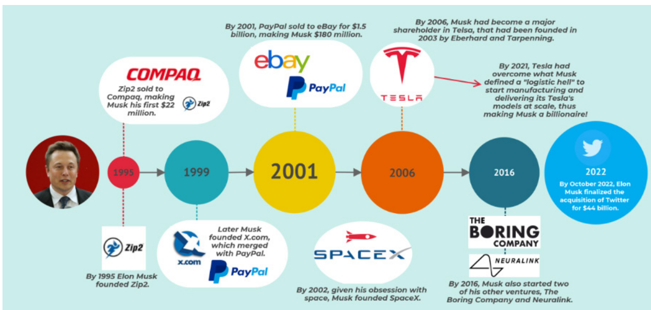
After a dreadful 2022, the recovery of risk assets, the decline of the dollar and significant regulatory improvements could lead Bitcoin to more than double its current price. Meanwhile, thousands of cryptocurrencies would not survive the 2022 crypto-winter and disappear.

SURPRISE #10 —

The fall of an icon [Probability: Low]

In a very surprising development, the Twitter turnaround story fails as thousands of companies start to boycott the social media platform. Elon Musk would then be forced to sell Tesla stocks to finance another rescue of Twitter, which would ultimately fail. Markets might then start to lose faith in Elon Musk, leading to a demise of his empire.

The Elon Musk entrepreneurial story



Source: Four-week MBA

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