Market Outlook

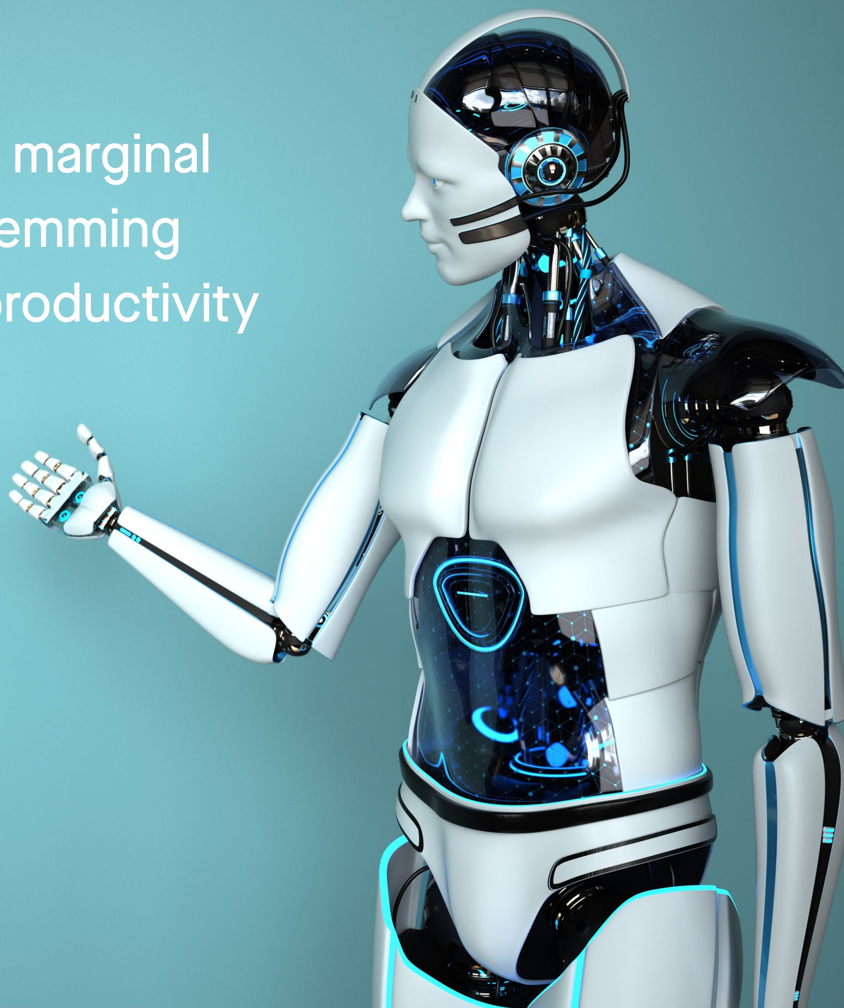
CLIMBING THE WALL OF WORRY

H2/2023

Risk assets are off to a very decent start of the year. While some key hurdles are now behind us, we believe that volatility could pick-up in the second half of the year as central banks might have to maintain restrictive financial conditions while economic growth is slowing down.

Syz PRIVATE BANKING

Analysts expect marginal improvement stemming from AI-driven productivity enhancements.



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INTRODUCTION

Are the skies finally clearing?

The first half of the year is over. After a dreadful 2022, equity markets have been doing well. By surpassing a 20% gain from the October low, the S&P 500 is technically in a new bull market.

The gains have been mainly driven by a limited number of mega-caps tech stocks driven by the Artificial Intelligence boom.

We note however that the rally has been broadening lately to other areas of the market, for example, value or small caps, which is a positive. Japan continues to perform well, while China disappoints.

Fixed Income have been generating decent gains as well, while commodities are by far the worst performing asset class in the first half of this year.

After last year's crypto-crash, Bitcoin is coming back with a vengeance. So far, it's the best performing asset year-to-date with a gain of more than 50%.

Indeed, markets have been climbing the wall of worry. The US debt ceiling drama is now behind us, the US banking crisis that we have been observing in slow motion seems to be stabilizing, inflation continues to cool down, G7 economies are likely to avoid a deep recession and last but not least, earnings have been surprisingly resilient as analysts expect margin improvement stemming from AI-driven productivity enhancements.

Does that mean it's time to celebrate and increase exposure to risk assets in portfolios?

Let's keep in mind a few remaining hurdles.

First, on the macro side, we might very well enter the stage where the most aggressive rate hike cycle since the 80s start to impact economic growth.

Furthermore, central banks seem reluctant to pause or cut rates, as inflation remains well above target.

Resulting in a situation where the Fed, and other central banks, are not our friends when the weakest parts of the economy start to tank. This is not a macro-economic and liquidity context we are used to.

Another hurdle is the fact that earnings growth expectations look too optimistic at a time when valuations are expensive. This combination means that there is little room for disappointment. Especially if we take into account the fact that markets seem very complacent at this stage.

The VIX, or fear index as it's commonly known, is below 14, investor sentiment surveys show a high level of optimism and money flows into tech stocks have been very aggressive recently.

So be cautious, any unexpected macroeconomic development or monetary policy decision could trigger a volatility spike.

To conclude, how should investors position their portfolios for the second half of this year? We believe that there are 3 golden rules to follow during these uncertain times.

1. **One, stay invested.** Market timing is a losing game. Given the high level of inflation, there is no alternative than to invest in risk assets to protect purchasing power.
2. **Two, "Go for quality".** Now is the time to invest in companies with strong management, a robust balance sheet, high profitability and wide economic moat. This applies to both equities and credit.
3. **Three, be opportunistic.** We need to use volatility at our advantage. Any market pullback can be used as an opportunity to buy quality stocks with a safety margin

And don't forget to look for opportunities on a broad basis. While some tech stocks are richly valued, other parts of the market look attractive. Japan, Europe and some emerging markets are not expensive. The same applies to value style and small caps in the US.

We wish you all the best for the second half of this year and we look forward to continuing the conversation.

Charles-Henry Monchau
Chief Investment Officer

H1/2023 Market review

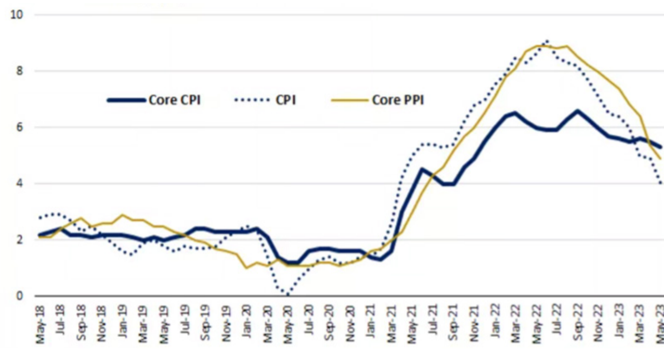
As inflation starts to cool, the Fed pauses its rate hikes. US equities are back in a bull market, while congress lifts the debt ceiling. Here are ten stories to remember from H1 2023.

STORY 1 —

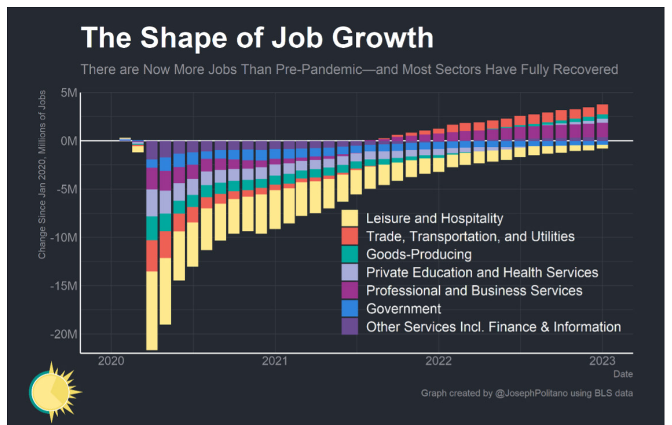
Inflation is cooling down

The first half of the year provided evidence that global inflation is in a downward trend. In the US, headline Consumer Price Index (CPI) hit a 2-year low (4%) in May, helped by declining energy prices and less upward pressure from food prices. More importantly, core CPI, which strips out volatile food and energy prices, also continues to moderate and now stands at its lowest level since November 2021. Core Producer Price Index (PPI) has also been declining.

Consumer Price Index and Producer Price Index Year-over-Year Change (%)



Source: Edward Jones



Source: Joseph Politano using BLS data

STORY 2 —

A resilient consumer

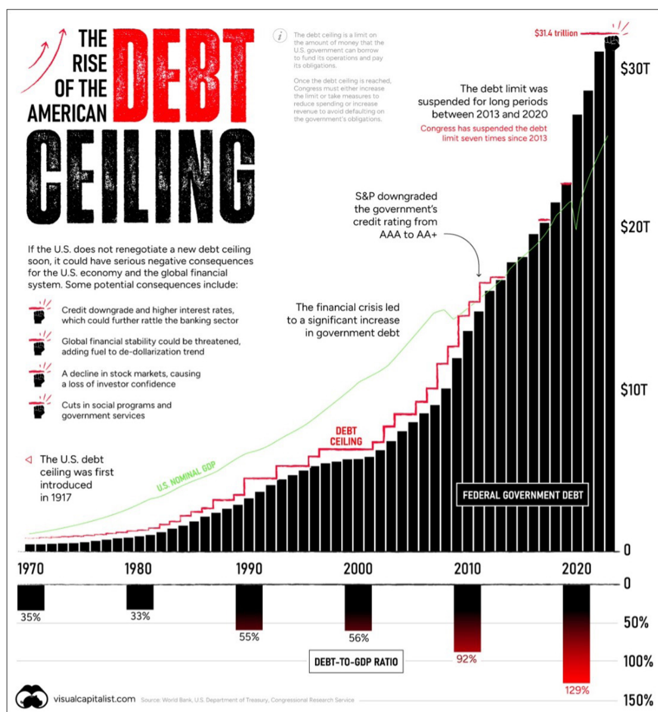
The pause by the Fed in June (see story #5) was mainly motivated by signs of deceleration in the broad economy. In the US, manufacturing activity has been contracting for more than six months, and business investment has declined materially, two cylinders of the economic engine that are misfiring. This weakness has been masked in the overall GDP figure by an exceptionally strong consumer, supported by very low unemployment and elevated wage growth. The same story applies to Europe. While a deep recession was feared at the end of last summer, the strength of the consumer and the resilience of the job market have been offsetting the impact of the energy crisis on the manufacturing activity.

STORY 3 —

Another debt ceiling drama

Set by the US Congress, the debt ceiling is the maximum amount the federal government can borrow to finance the obligations that elected officials and presidents have already approved. The ceiling, which stood at $31.4 trillion, was created over a century ago. Since 1960, Congress has raised or extended the debt ceiling 78 times. As of the end of January, the US debt ceiling was effectively hit, forcing Republicans and Democrats to reach an agreement on the conditions to raise it once more. Early June, after weeks of

negotiations and two days before the date which would have resulted in a potential technical default by the US federal government, President Joe Biden signed legislation that lifted the nation's debt ceiling. This deal averted a situation where the US would start running short of cash to pay all of its bills, which would have sent shockwaves through the US and global economies. Republicans had refused to raise the country's borrowing limit unless Democrats agreed to cut spending, leading to a standoff that was only resolved after weeks of intense negotiations between the White House and House Speaker Kevin McCarthy. This brinkmanship led to an increase of US Credit Default Swap as well as bond volatility. The final agreement, passed by both houses, suspends the debt limit until 2025 – after the next presidential election – and restricts government spending. It gives lawmakers budget targets for the next two years in hopes of assuring fiscal stability as the political season heats up. This will ensure the government can borrow to pay debts already incurred.

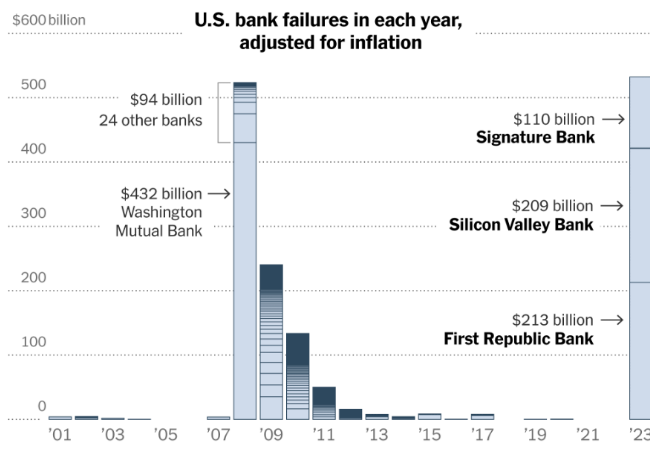


Source: Visualcapitalist.com

STORY 4 —

A US bank run in slow motion

Major US bank failures took place during the first half of this year. Silicon Valley Bank, Signature Bank and First Republic bank collapsed at record speeds, in a perfect bank run example, in which too many depositors withdraw their funds from a bank at the same time. Adjusted for inflation, the cumulated assets of US bank failures so far this year is as high as 2008. In the United States, regional banks continue to experience customer withdrawals, although it has been stabilizing recently. Meanwhile, money market funds are recording massive inflows. One of the major negative consequences of the US banking crisis is the tightening of commercial banks lending standards.

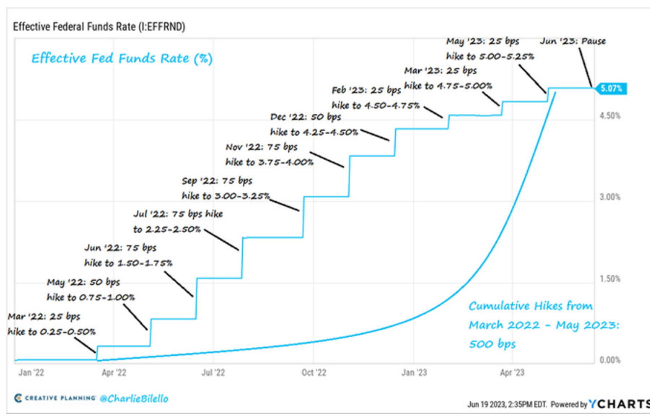


Source: The New York Times

STORY 5 —

A pause at last for the Fed

After 10 consecutive meetings with rate hikes, the Fed finally decided to pause, holding the Fed Funds Rate at a range of 5.00-5.25%. There is no guarantee that this will be the last rate hike of this cycle; at the time of our writing, markets believe that June was a "skip" as the curve currently prices in an 80% probability of another rate hike in July. With regards to the ECB and the BoE, it seems that more rate hikes are coming as well.



Source: Charlie Bilello

STORY 6 —

Despite rate hikes and Quantitative Tightening, net liquidity has been a positive for equities

One of the reasons behind the strong performance of equity markets has been the upward trajectory of net liquidity. While Quantitative Easing (QE) has been over for several months, the draining of the Treasury General Account (TGA) to keep the economy afloat ahead of the debt ceiling X date has been maintaining liquidity in an upward trajectory and helping to lift US equity prices upward. Likewise, the Fed Bank Term Funding Program (BTFA) created in March to support US banks also acted as a "stealth QE" to some extent.

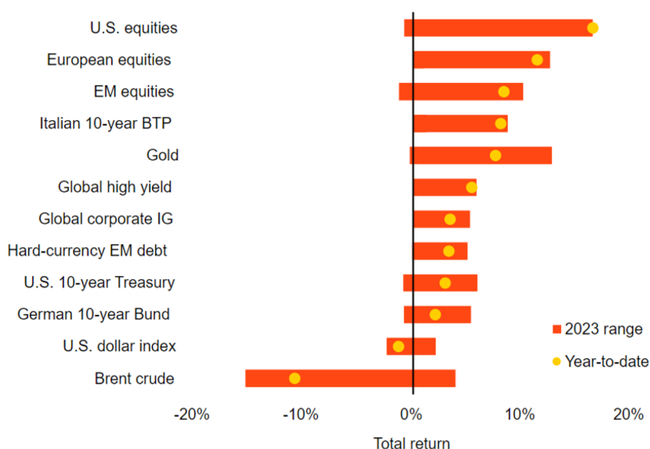
S&P500 performance and Fed net QE since the pandemic began

Source: Apollo

STORY 7 —

A strong start to the year for both equity and fixed income. Commodities are the worst performing asset class

In 2022, the traditional equity/bond portfolio recorded its worst performance since the great financial crisis with both equity and bond markets posting losses. Fast forward to 2023 and the asset classes performance dashboard looks quite different. As of June 20th (see below), global equity markets are up significantly with the best performing region being the US, ahead of Europe and Emerging Markets. Bond markets also posted positive performances, but underperformed equities. Despite a slight decline of the dollar index, commodities are the worst performing asset class with a sharp decline of crude oil. One notable exception is gold, which recorded a strong performance in the first quarter. Last but not least we note that cryptocurrencies recovered part of last year's losses; bitcoin is up roughly 50% since the start of the year.

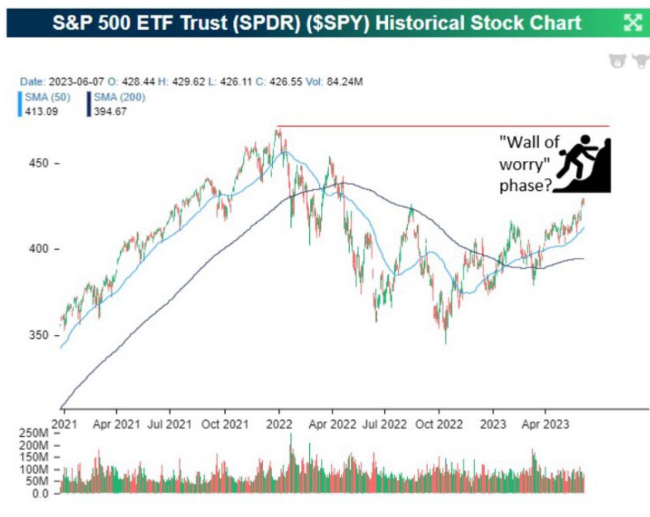


Source: Blackrock

STORY 8 —

The S&P 500 has entered bull market territory

The S&P 500 has been climbing the wall of worry, surging by 21% since its October low, surpassing the 20% that many hold as an unofficial threshold for entering a bull market. The S&P 500 has recouped all of its losses since the cycle's first rate hike in March 2022. At the time of our writing, Nasdaq remains the best performing major US equity index on a year-to-date basis, while the Dow Jones Industrial Index and the Russell 2000 index are lagging.



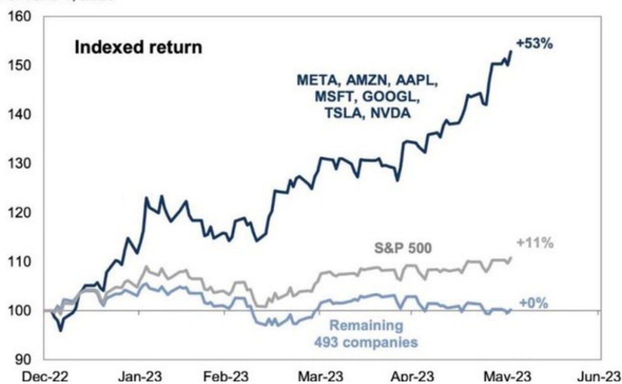
Source: Bespoke

STORY 9 —

A narrow US market driven by AI mania

To put things into perspective: 10 stocks have contributed 90% of the S&P 500's 13.0% gain this year (as June 19th), the most concentrated market ever, Bernstein says. Most of these stocks have been driven by the "Artificial Intelligence mania" as investors believe that companies will devote major capital expenditures to AI tools in order to enhance their profit margins. The "Magnificent 7" (Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla) now make up 28% of the S&P 500. What is even more impressive is that without their remarkable 50% performance year-to-date the S&P 500 would be roughly flat in 2023.

The market is paying major valuation premiums for stocks which are deemed to benefit from this AI-driven capex. Among them, the semiconductor company Nvidia, which reached the $1 trillion market cap threshold and which trades at more than 40 times price to sales.

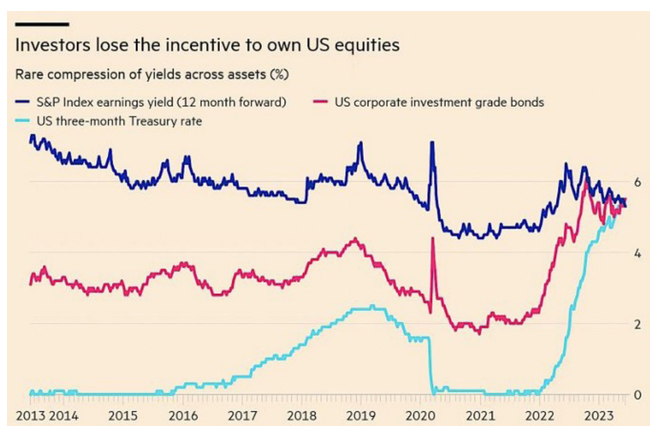


Source: Goldman Sachs

STORY 10 —

Cross-assets valuations exhibit a unique phenomenon

For the first time ever, the yield on cash, bonds & equities is the same. The yield on 3 month US Treasury bills was 5.3% after the Fed maintained interest rates between 5-5.25%. That is the same level as the expected 12-month forward earnings yield across the S&P 500.



Source: FT, Pictet, Bloomberg

Valérie Noël
Head of Trading

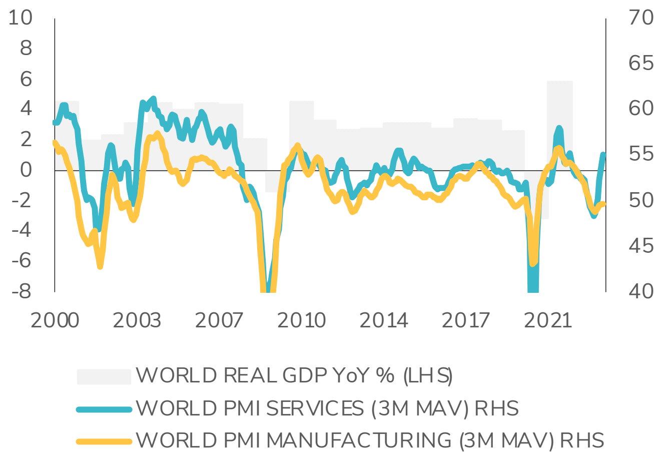
MACRO VIEW

Slower growth and inflation ahead, but no reversal in central banks' policies

The first part of 2023 has been a tale of two halves for the global economy. The reopening of China has failed to live up to expectations, central banks have kept raising interest rates, and cracks have appeared in the financial system as early symptoms of the sharp tightening in financial conditions.

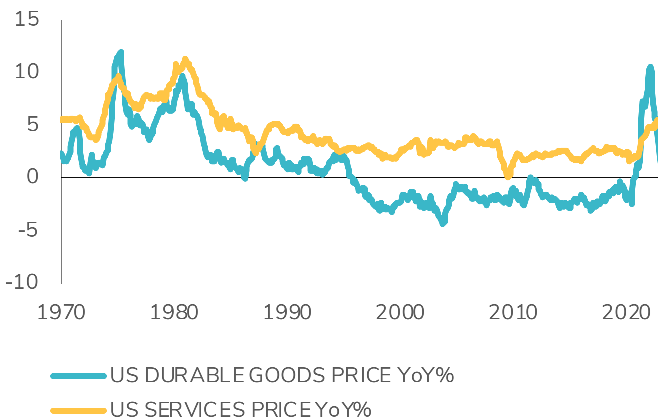
On the other hand, domestic demand has remained very resilient, supported by high employment in developed economies and the end of Covid-related restrictions in China. A divergence has also been observed in inflation dynamics, as energy, commodity and supply-chain related price trends clearly point to a sharp slowdown in inflation for the second half of the year, while prices of services and wage growth show no sign of slowdown yet.

World Services & Manufacturing activity



Source: Banque Syz, FactSet

US price inflation for Durable Goods and Services



Source: Banque Syz, FactSet

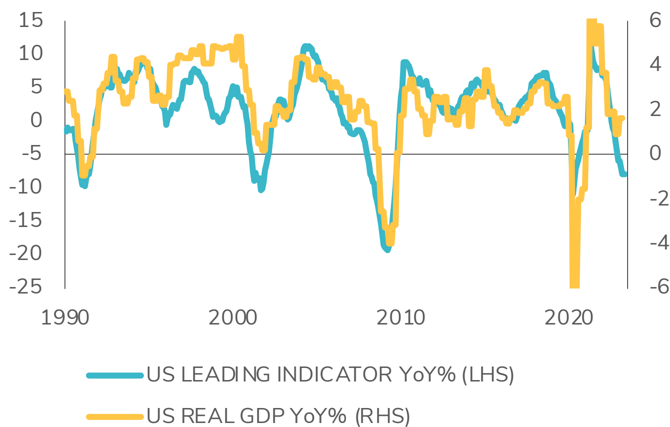
This unusual combination of weakness in cyclical parts of the economy, normally pointing to an imminent end of the current growth cycle, and of sustained household consumption still supporting solid expansion, opens several questions for the second half of the year. Uncertainty is high around the outlook for economic growth, inflation, and central banks' policies, especially as some "historical" economic patterns and relationships may have been altered by the accumulation of economic and geopolitical shocks of the past three years. Risks predominantly point to the downside for the months ahead, but having a view on the various moving part of the current macro-economic landscape is crucial to be prepared for the variety of potential outcomes.

Will the US economy experience a recession in the second half of 2023?

Since the later part of 2022, a growing number of indicators have started deteriorating in the US economy. Cyclical, interest-rate sensitive sectors are experiencing a hangover from the post-Covid period of frantic investment and precautionary inventory building, only made worse by the sharp rise in interest rates and tightening in financing conditions.

As a result, real estate investment and industrial activity have already significantly slowed, with new orders pointing to further decline in the months ahead. The weakness in those sectors, usually leading indicators of overall GDP growth, and the lagged impact of the Fed's rate hike cycle

all suggest that the US economy is at risk of experiencing a significant growth slowdown in the second half of the year. A recession is even an actual possibility when looking at historical precedents of comparable rate hike cycles and leading indicators' deterioration.



Source: Banque Syz, Factset

On the other hand, the main engine of US economic growth, household consumption, continues to be just fine. Indeed, disposable income keeps rising with record high employment and strong wage growth, and, unlike in 2022, it is now even rising in real terms (excluding inflation). This means that the current pace of consumption can be sustained even without the support from temporary factors such as remaining excess savings from the Covid period. Given the importance of household consumption (70% of US GDP), it is difficult to imagine a US recession without a downturn in employment and consumption.

Therefore, the question around the occurrence and timing of a recession in the US can be brought down to the evolution of the labor market in the coming months. If the job and wage growth remains solid, a recession is likely to be avoided, with GDP growth likely to remain subdued due to all the cyclical headwinds, but positive thanks to resilient consumption. On the flip side, if, or when, unemployment starts to rise, consumption will likely weaken due to reduced disposable income and declining household confidence and the economy will likely experience some form of recession.

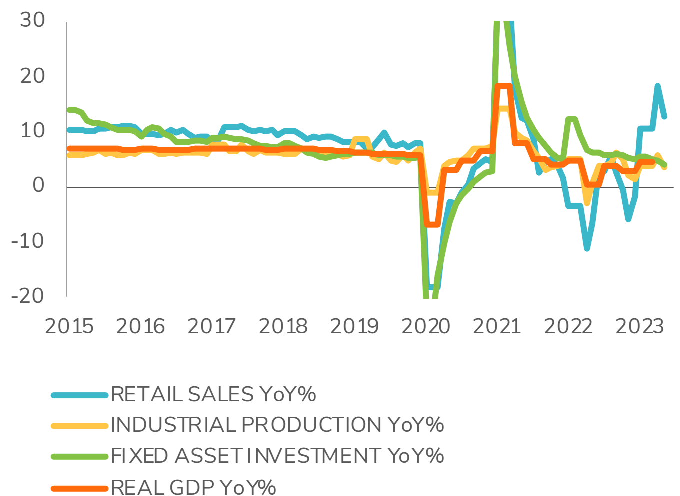
Our view is that the combination of cyclical weakness and higher interest rates will eventually impact the job market in the second half of the year and drive the US economy into recession around the end of 2023 or the beginning of 2024. We expect only a "mild" recession, resulting from the impact of more restrictive financial conditions. We believe that a "deep recession" is only a tail risk that would likely involve some form of stress in the financial system.

Will China's growth eventually accelerate?

China has experienced three years of weak economic growth since 2020, under the combined effects of Covid-related restrictions and government crackdown on several sectors (real estate, internet, education etc.).

At the end of 2022, the relaxation of strict anti-Covid policies triggered expectations of a growth acceleration for 2023, also fueled by some targeted easing in credit conditions. However, the impact of those less restrictive policies have not been as spectacular as expected. Domestic consumption and activity in the service sector have surged as Chinese households were allowed to get out and travel again, but investment spending and manufacturing activity have not experienced a similar recovery, instead merely stabilizing around a positive but soft pace of expansion.

Consumption has picked up in China with the reopening, but GDP growth will merely stabilize in 2023



Source: Banque Syz, Factset

Recently, additional measures to support economic growth have been unveiled (rate cuts, less restrictive lending policies) but their magnitude has remained contained, suggesting that they were aimed at stabilizing the economy in a context of slowing global growth, rather than engineering an actual pickup in economic activity. Indeed, the government is willing to avoid any exaggerate stimulus that may lead to renewed excesses, in real estate or in the stock market. Policy easing is implemented gradually and cautiously, a careful fine tuning designed to stabilize economic growth at a sustainable level.

Our view is that China will no longer be a headwind to global growth as it has been in 2022, but that it will not

be the source of dynamism that was hoped when starting 2023 neither. The Chinese economy is in a cycle of its own, decorrelated from the cycle of large, developed economies and much more focused on internal activity than on exports. This refocusing on domestic drivers of growth fits into the long-term strategy of development of the Chinese economy. It is reinforced by the global geopolitical environment where strategic independence is becoming increasingly important for all large economies.

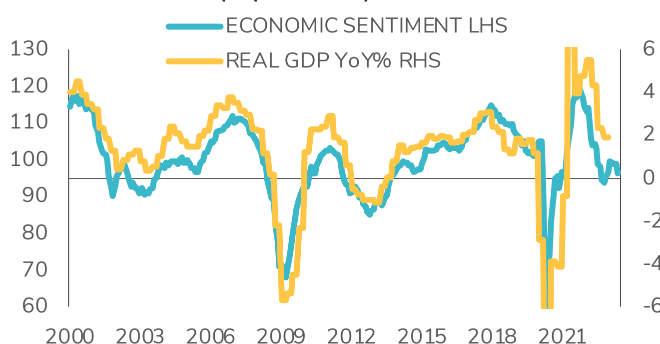
What outlook for Europe?

In many respects, European economies share similarities with the situation of the US economy. They enjoy firm growth in domestic demand and service sector activity, supported by record low unemployment rates and significant wage growth, while the cyclical components of the economy are weak. However, Europe also faces much more directly the impact of the sanctions on Russia, via energy prices and via lower export demand for industrial and manufactured goods. The prospect of an energy crisis over last winter triggered a “mini-recession”, even if the impact was eventually milder-than-feared, thanks to broad-based efforts to reduce energy consumption and a warmer-than-usual winter.

Since then, economic activity has picked up, led by consumption in services. But the cyclical parts of the economy have remained under pressure from disappointing China and external demand, and gradually less supportive monetary and fiscal policies.

Persistent inflationary pressures and rising wages in the Eurozone and the UK leave little choice to the European Central Bank (ECB) and the Bank of England (BoE) than to keep raising short-term rates for the time being. This tightening in financial conditions will likely weigh on growth, in the second half of the year. Besides that, energy supply remains a Damocles sword over Europe’s growth outlook: a cold winter, renewed upward pressures on energy prices or new geopolitical developments could rapidly revive the concerns of late 2022 and weigh significantly on economic activity once again.

Growth in Europe has picked up from the mild winter recession, but lacks momentum for a proper recovery



Source: Banque Syz, Factset

Switzerland might be less sensitive to energy prices than the UK or the Eurozone, but weaker demand from its European neighbors, coupled with soft demand from China, will likely affect the export-sensitive Swiss economy.

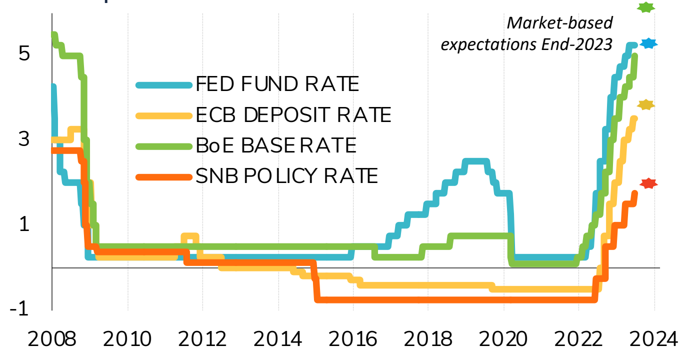
Our view is that Europe is set for a soft expansion in the second half of the year, with clear downside risks from any unfavorable developments on the energy and climate front. As in the United States, the strength of the labor market is so far a powerful support to domestic demand and service sector activity. But if the ECB, BoE and Swiss National Bank (SNB) finally are successful in taming upward pressures on wages and prices, it may weaken this key growth driver too, and create conditions for another “mini-winter recession” at the end of the year or in early 2024.

Will the Fed (and other central banks) reverse course and cut rates?

All main central banks in developed markets have engaged into an accelerated rate hike cycle since last year. The decade-long era of super low (or negative) rates has ended by elevated inflationary pressures in a context of economic growth resilience. The tightening in financing conditions has been so brutal that markets have been skeptical all along about the ability of the economy to withstand such increase in rates and convinced that this rise in rates will have to be reversed rapidly with rate cuts once growth and inflation cool down.

After the latest round of rate hikes this spring, uncertainty surrounds the outlook for central banks’ action in the second half of the year. The current combination of resilient economic activity and inflation is still far above the central banks’ targets and forces them to remain focused on inflation risk, with possible additional rate hikes in the months ahead. However, the rate hike cycle is very likely nearing its end, and financial markets continue to expect that the Fed or the ECB will have to reverse course and cut rates later this year or in 2024.

The end of the rate hike cycle is near, but rate cuts may not come as fast as expected



Source: Banque Syz, Factset

Our view is that the slowdown in growth and inflation expected in the second half of the year will lead developed markets' central banks to halt their rate hike cycle at, or not far from, current key rate levels. However, in our scenario of a moderate global growth slowdown and potential "mild" recessions on both sides of the Atlantic, the potential for a central banks' U-turn on rates appears quite limited. With underlying inflation still clearly above their targets, central banks may initially welcome an "orderly" growth slowdown as a cost to pay for bringing the inflation genie back into its lamp. The Fed still has vivid memories of the mid-70's, when it cuts rates too early in response to slowing growth, only to see inflation pick up rapidly and require the strong hand of Paul Volcker to finally bring it down at the expense of a double recession. Therefore, in this context, we expect that central banks, once done with rate hikes, will keep their key rates stable at restrictive levels, until there are clear and undisputable signs that underlying inflationary pressures and their source, tight labor markets and rising wages, are eradicated for good. Rate cuts might only be contemplated if the economic situation deteriorates much faster and much more significantly than what we expect in our scenario.

Adrien Pichoud

Chief Economist

PORTFOLIO CONSTRUCTION

Asset allocation

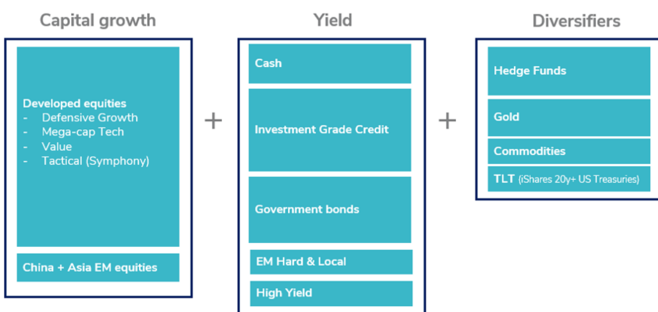
Overall, the weakness of the macro and fundamentals is not compensated by the positive view on technicals. This leads us to keep our cautious stance on equities.

We believe that the current context favors an “all-weather” portfolio strategy through a diversified exposure to developed equities, with a tilt towards the technology sector, as it provides regular cash flows and an attractive exposure to the AI theme. We have reduced our exposure to emerging markets and commodities as the economic recovery in China is much weaker than anticipated and geopolitics weigh on the general sentiment of foreign investors. Finally, we are still monitoring very closely the evolution of earnings growth momentum and the magnitude of the expected US recession, in the second half of the year.

Within Fixed Income, we have increased our stance on rates to “positive” and we maintain a positive view on credit. We have increased both the quality and the duration of the bond allocation of our portfolios. Globally, we have reduced the complexity of the bond allocation by focusing on government bonds, high quality corporate bonds and reduced emerging debt, convertible and bond funds in general.

The changes in our Fixed Income allocation mentioned above, longer duration, less credit and more sovereign are strategic because the environment has fundamentally changed, after a decade of zero interest rates. Indeed, the strong (and painful) upward move of bond yields in 2022 had fundamentally changed the bond landscape and the set of opportunities. The hunt for yield of the previous decade was justified by a zero-interest rate environment. This is not true anymore and low-risk-with-a-decent-yield opportunities exist now. Additionally, a higher quality and longer duration bond exposure will improve the risk/return of the portfolio, if the macro environment deteriorates in H2.

An illustrative view of a balanced portfolio (the size of the boxes roughly indicates the relative allocation of the various “buckets”)



Finally, in terms of decorrelated positions, we maintain an exposure to real assets, such as gold and hedge funds to bring diversification to the portfolios.

The weight of the evidence

Our tactical asset allocation process is based on five indicators. Below is a summary of our current views.

Macro & Fundamental Factors
(Leading indicators)

→ Macro-economic cycle: NEUTRAL

→ Liquidity: NEGATIVE

→ Earnings growth: NEGATIVE

→ Valuations: NEUTRAL

Market Factors
(Coincident indicators)

→ Market dynamics (Breadth, Sentiment, etc.): POSITIVE

Luc Filip
Head of Discretionary Portfolio Management

EQUITIES

The benefits of staying selective

Despite an environment of heightened uncertainty due to the turmoil in the banking industry, its impact on credit availability, concerns about inflation and interest rates, the fear of a potential economic recession and the recent debt ceiling crisis in the US, global markets have ended the first part of the year on a strong note.

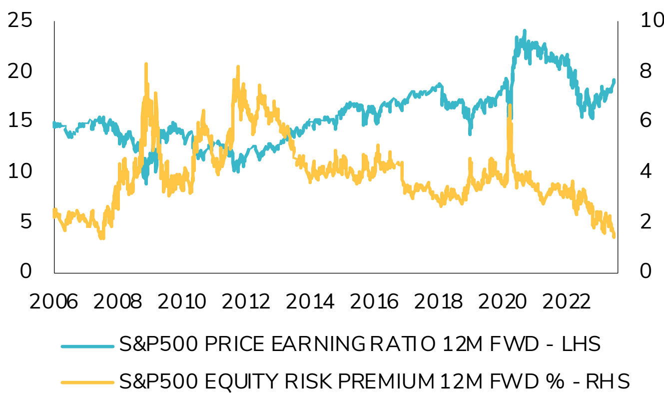
Valuations remain a point contention; the MSCI World AC Index is now trading at a price-to-earnings ratio of 16.3x 2024 earnings estimates, a rather rich valuation (vs. its 20-year historical median), particularly now that equities are competing with attractive bond yields.

In the US, the equity risk premium has contracted since its peak in 2020, as the increase in yields (i.e., 10-year from 0.5% to 4.0%) has made bonds more attractive compared to equities. The parallel drop in market's valuation from 22.5x to 18.7x was not enough to balance the impact of higher interest rates on the Equity Risk Premium (ERP). The ERP and valuation dynamics have stabilized so far in 2023.

12-month forward P/E across key geographies

	Current	20Y Median	Current vs Median
US	18.7	15.8	2.9
Eurozone	12.1	12.8	-0.7
Switzerland	17.3	15.1	2.1
UK	10.0	12.4	-2.4
Japan	14.2	14.2	-0.1
EM	11.7	11.3	0.4
World	16.3	15.0	1.2

Source: J.P. Morgan, IBES, MSCI indices



Source: Banque Syz, FactSet

While the risk of stronger than expected interest rate increases later this year appears limited, the outlook for equity markets is now dependent on earning revisions. If valuations deteriorate following a downward earnings revision, we could see a continuation of the decline in ERP. So far, earnings have continued to surprise on the upside, even though margins have been contracting with pricing power starting to wane.

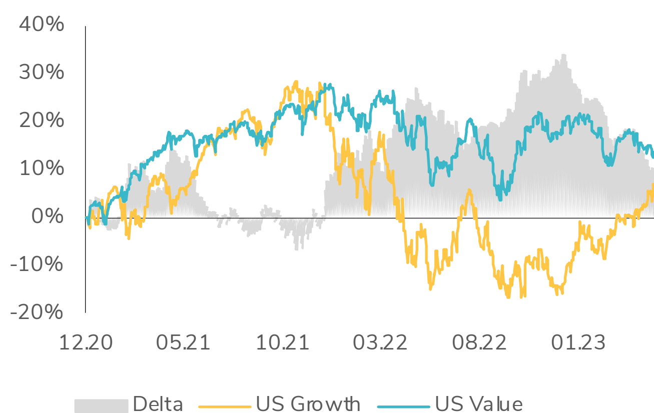
The outlook for earnings in the face of the slowing economy remains a concern. Consensus is calling for flattish global earnings this year, and an acceleration into next year. With no downside projected, expected profits seem to be already priced in stock prices.

	2023e EPS Growth, %		2024e EPS Growth, %	
	Current	Jan 23	Current	Jan 23
MSCI World	18.7	15.8	2.9	15.8
S&P 500	12.1	12.8	-0.7	12.8
Stoxx 600	17.3	15.1	2.1	15.1
Euro Stoxx	10.0	12.4	-2.4	12.4
FTSE 100	14.2	14.2	-0.1	14.2
Topix*	11.7	11.3	0.4	11.3
EM	16.3	15.0	1.2	15.0

Source: J.P. Morgan, IBES,
*for Year Ending March 2024 and March 2025

As inflation has recently shown signs of moderation and economic growth seems to be declining, this could lead central banks to hold interest rates at current levels before eventually easing next year once inflation is totally under control, a bullish prospect for equities.

Nevertheless, as we believe that the global economic and earnings growth momentum will decelerate, we prefer to remain cautious and defensive for the remainder of the year and continue to favour growth stocks which again are outperforming value.



Source: Banque Syz, FactSet

In the US and Europe, we continue to look for high quality growth stocks with resilient long-term growth drivers. As bottom-up investors, we look for sound companies whose strategies, competitive positions, solid financials, and steady cash flows can drive above-average earnings growth and share price appreciation, while offering safe dividends, ideally at undemanding valuation. These high-quality stocks can generally weather rate increases and/or slowing economies. We particularly like healthcare which tends to have lower sensitivity to macro trends in general and could hold well in case of a poor market performance.

We remain cautiously optimistic about selected large techs (particularly semiconductors). Despite their rich valuation and significant recent gains, we believe that these stocks will continue leading the market driven by powerful secular growth themes such as cloud computing or Artificial Intelligence.

We remain cautiously optimistic about selected large techs (particularly semiconductors) and believe these stocks could continue to lead the market even though they are richly valued, and that they have gone up sharply. Nevertheless, we believe that they will continue to benefit from powerful secular growth themes such as cloud computing or Artificial Intelligence.

As for Asia, China's "reopening" growth has been disappointing so far. Expectations are for the introduction of measures aimed at supporting economic activity and more specifically the real estate sector. An improving outlook for the Chinese economy, should also support the whole region.

We continue to like India as a secondary play, as the country will probably be the main beneficiary of the global manufacturers willingness to curb their exposure to China, adopting a "China plus one" strategy.

We expect Japan to continue to outperform thanks to Asia's better macro dynamics, but also thanks to the country's new corporate governance reform, which encourages companies to increase dividends and start buybacks programs. Japan, more precisely the Nikkei, has also benefited from the semiconductor sector sharp increase, which is expected to see higher investment as many countries and manufacturers are looking to diversify their exposure away from China.

Since it is difficult to determine what is currently priced in the global equity markets and as uncertainties will certainly continue to prevail, particularly around earnings growth momentum and geopolitical events, we choose to remain defensively positioned for the time being.

In summary, our tactical geographical preference remains for the developed markets, which have been supported by a very resilient macro backdrop so far. As for sectors, we continue to favor defensive sectors such as Healthcare and both Consumer Staples and Discretionary.

Nevine Pollini
Senior Investment Analyst

Simon Oederlin
Senior Portfolio Manager

FIXED INCOME

Unlocking the power of Fixed Income: A diversifier that "carries"!

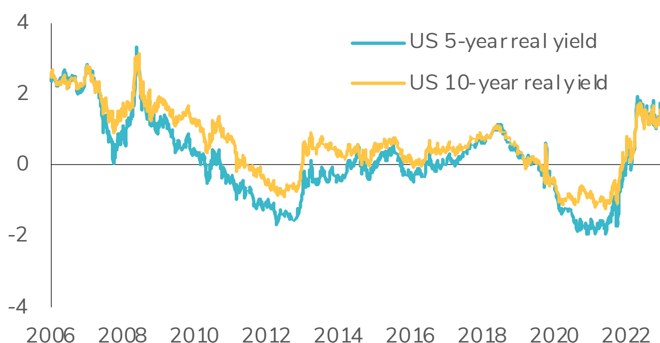
After two challenging years, bonds have regained their appeal, with high absolute nominal yields and a negative correlation with equities. In our Outlook for the first half of the year, we emphasized the pivotal role played by the carry component of yields in shaping the landscape for fixed-income investments.

As anticipated, the resurgence of carry proved instrumental during this period, while the 10-year US Treasury yield remained stable, reflecting levels similar to the year's beginning. Despite the absence of declining yields and a more pronounced inversion of the yield curve, the fixed income market has witnessed a gain of nearly 2% since the start of the year. While challenges persist in achieving a sustainable decrease in yields, the outlook for fixed-income investments for the second half of the year appears promising. Inflationary pressures are subsiding, central bank rate hike cycles are nearing their end, and fixed-income investments offer enhanced diversification within multi-asset portfolios, as evidenced by their renewed negative correlation with equities. **We are thus positive on the fixed income asset class for H2 2023 with a focus on high quality segments, mainly government and investment grade bonds.**

Government Bonds

We turn positive on government bonds as we perceive an attractive asymmetry surrounding rates, with limited upside risks and the potential for a decline in rates, should the macro environment deteriorate. On the one hand, the front end (up to 2 years maturity) of the yield curve offers sufficient carry to offset any potential future rate hikes, considering that the Federal Reserve is still expected to implement two more hikes in order to reach a terminal rate of 5.6%. On the other hand, the intermediate segment (from 2 to 10 years) of the yield curve presents compelling entry points for long-term investors, as US real rates (chart 1) have reached levels not witnessed since the period before the Great Financial Crisis.

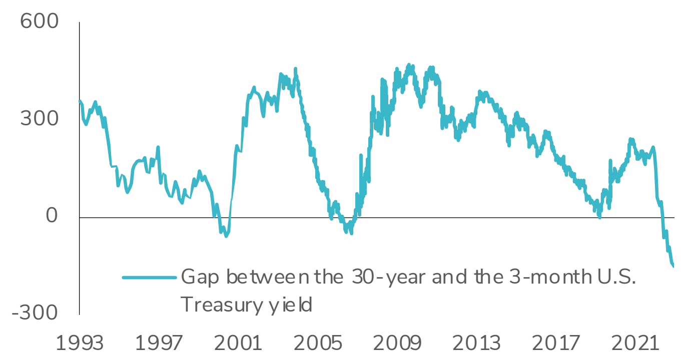
Chart 1 - Levels of real yields in U.S. Treasury market



Source: Bloomberg

Despite some positive factors such as the declining rate volatility (as indicated by the MOVE index) and the return of negative correlation between rates and equities, the attractiveness of the back end (10 years or more) of the yield curve is less compelling, given that it already reflects a significant growth deceleration, as indicated by the level of yield curve inversion (chart 2).

Chart 2 - Gap between the 30-year and the 3-month U.S. Treasury yield



Source: Bloomberg

In other rate markets, we maintain a cautious approach towards investing in GBP, EUR, and CHF government bonds, as the end of the interest rate hike cycle appears to be farther off compared to the United States. Higher terminal

rates by Central banks, such as 4.0% for the European Central Bank (ECB), 2.2% for the Swiss National Bank (SNB) and 6.0% for the Bank of England (BoE), than current market is expecting could exert continuing pressure on rates. In Europe, Quantitative Tightening will be in full swing with a full roll-off of the ECB's Asset Purchase Program (APP) starting in July. Persisting wage pressures, as well as a possible resurgence of the energy crisis could be a potential threat in the coming months. But overall, the picture has improved compared to 6 months ago, and positive signals have emerged such as a favorable trend in inflation as witnessed by declining selling price expectations among eurozone companies (chart 3). Taking this into consideration, we have adjusted our stance from unattractive to cautious, reflecting a more neutral positioning.

Chart 3 - German 10-year yield vs Eurozone Selling price expectations

Source: Bloomberg

Corporate bonds

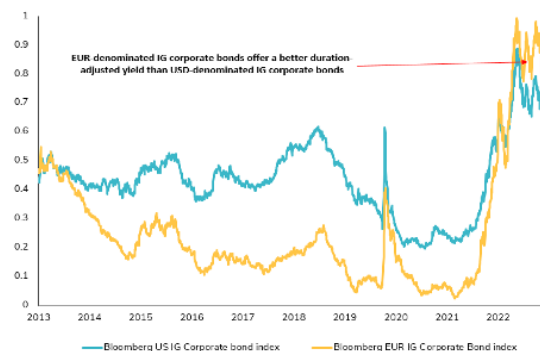
Entering 2023, we held the conviction that credit segments would deliver strong performance, and that proved to be the case. Over the first half of the year, credit indexes performed well, generating total returns of more than 2% and 5% for Investment Grade and high yield segments respectively in the US and Europe. While we maintain a positive stance on credit, our focus has shifted towards high-quality segments, capitalizing on the steepness of the credit spread curve, which offsets the inverted government yield curves. The relative attractiveness of Investment Grade corporate bonds compared to equities is currently at its highest level in over two decades (chart 4), reinforcing the appeal of this fixed income segment.

Chart 4 - U.S. Investment Grade corporate bonds yield vs S&P500 earnings yield

Source: Bloomberg

We favor EUR credit over the US market, as it offers better returns adjusted to duration risk, after a higher spread widening due to deeper recession concerns in Europe and hence higher default rates probabilities. The European premium (chart 5) has also increased following the Credit Suisse event, creating compelling investment opportunities.

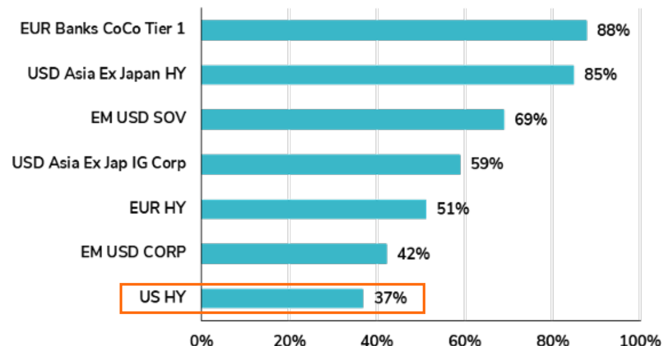
Chart 5 - Available yield adjusted by duration



Source: Bloomberg

However, we believe that High Yield (HY) investments are currently unattractive based on spread valuation. The current valuation of US high yield spreads implies modest default rates and the absence of a near-term recession. Although we acknowledge that high yield bonds are not expensive in absolute terms, they are the most expensive segment within the fixed income space when viewed in relative terms (chart 6).

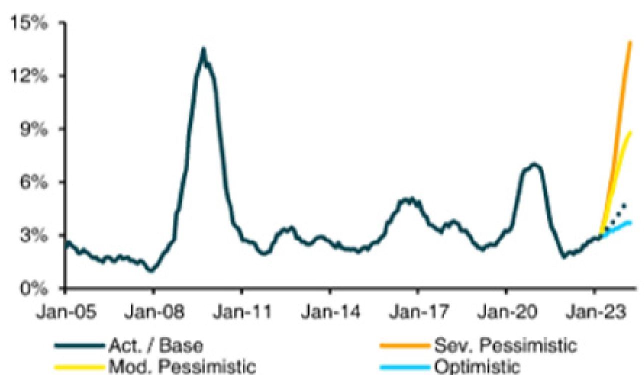
Chart 6 - Percentage of yields of fixed income indexes since 2000 that are lower than current ones



Source: Bloomberg

The strong start of 2023 was driven not only by the resilience of economies but also by technical factors such as a sluggish HY primary market, which more than offset massive outflows from high yield funds. Expectations of a recession and tightening financial conditions are likely to lead default rates higher, although they remain historically low. According to Moody's latest study, global High Yield corporate defaults are expected to peak at 5% by the end of April 2024 (chart 7) driven by higher borrowing and input costs and tighter lending conditions. Given these considerations, we prefer to adopt a cautious approach to safeguard portfolios against excessive volatility, favoring investments in the Investment Grade (IG) segment over High Yield.

Chart 7 - Moody's 12m trailing global speculative grade default rates (%)

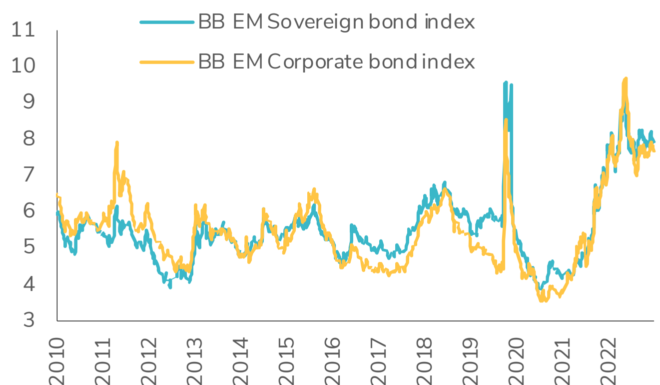


Source: Moody's

Emerging markets

Emerging markets (EM) had a strong performance in the first half of 2023, particularly in the EM local currency debt segment. This segment benefited from the near end of monetary policy tightening in several Emerging Market countries (especially in Latin America), as well as the weakness of the U.S. dollar. Additionally, in terms of valuation, absolute yields in all EM fixed income segments are attractive, thanks to the global rate levels (chart 8).

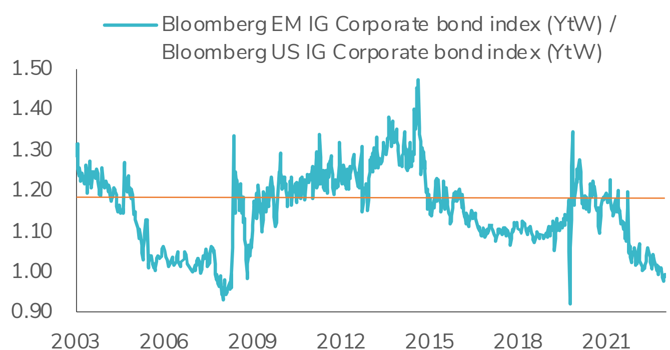
Chart 8 - Yield to worst of Emerging Market Sovereign and Corporate bonds indexes



Source: Bloomberg

However, there is more heterogeneity in credit spreads within EM. Specifically, EM Investment Grade (IG) corporate bonds are considered expensive (chart 9) due to their strong fundamentals and low refinancing activity in the primary market. Conversely, EM High Yield (HY) corporate bonds are in a cheaper territory, as idiosyncratic risks have already surfaced (e.g., Light, B2W) and volatility in the Chinese real estate market has been exceptionally high once again.

Chart 9 - Yield ratio between EM IG and US IG corporate bonds



Source: Bloomberg

While we exercise caution with regards to EM IG bonds, as they lack a premium over their U.S. IG counterparts, numerous opportunities have arisen within EM high yield segments. These opportunities hold the potential to add value in the short-term.

In summary, the fixed-income outlook for H2 2023 indicates promising prospects for investors, with a focus on high-quality segments in government and investment-grade bonds. While challenges persist, the overall outlook is positive, supported by favorable macroeconomic factors and the potential for enhanced diversification within portfolios. Vigilance is advised to navigate potential risks and seize opportunities in this dynamic fixed-income landscape.

Gaël Fichan
Senior Portfolio Manager & Head Fixed Income

Fabrice Gorin
Deputy Head of Discretionary Portfolio Management

PRIVATE MARKETS

Navigating valuations and opporunities

The expected contraction in private market valuations due to the "lag effect" didn't really materialize so far. Some strategies suffered mark-downs, while others were flat or up, but ultimately, private markets didn't suffer the same volatility as their listed counterparts. Those that have been waiting for a wave of distressed opportunities or interests changing hands at deep discounts through secondary market transactions, must continue to be patient. The expected forced selling of private market assets due to the "denominator effect", a situation in which the public holdings of a portfolio decline in value, while private assets' values hold firm, looks less obvious now that equity indices have somehow bounced back.

With higher interest rates, the pressure on valuations is here, but not significant, except in macro sensitive sectors. Long dated cash flows, such as in technology, which were re-rated materially in 2022 are still sitting at levels deep below their peaks. That being said, most other private market assets have managed to grow their valuations through top-line growth and strong operating margins, more than offsetting a muted multiple compression.

With this framework in mind, we believe it is important to remember why private markets are attractive. Over the last 15 years since the GFC, private markets have performed very well due a combination of global growth, low interest rates and multiple expansions that lifted all boats. Given the economic slowdown and geopolitical uncertainties such as China - US tensions or the ongoing Russia-Ukraine war, we believe there are more risks to the downside than to the upside. Selectivity becomes ever more crucial in this environment, as "buying the index" may not provide the same returns as in the past. We believe skilled investors can create value for portfolios in all environments by investing in sound businesses and accelerating their growth and profitability through value creation initiatives. Such value creation could be led by organic or external growth drivers.

Beyond capturing a liquidity risk premium, private market investors have two main advantages: first, they have access to more information in their due diligence process, allowing them to take informed decisions and being able to structure their investments with more downside protections. As capital terms shift from being "demand-led" to "supply-led", this creates positive dynamics. Second, private market investors have more time to let their capital impact a positive transformation, leading to higher value creation potential. As expressed in our previous posts, we believe investors should not time markets but keep the pace of their allocations throughout market cycles. The current vintages are not different and may provide very satisfactory returns.

Looking more closely at the opportunity set for private markets, we identify two main areas where our team will focus most of their attention. We continue to focus on 'buy and build' strategies when a company expands its operations by acquiring a platform company with developed expertise that it can then build out. Strong platforms are in a unique position to consolidate their fragmented markets by acquiring weaker capitalized competitors.

We are also starting to see interesting dynamics for 'special situations' investing, particularly by positioning ourselves as liquidity providers to constraint asset owners. Secondary transactions should become increasingly attractive, especially in asset classes with less capital available such as private credit and real estate secondaries, or smaller private equity portfolios overlooked by traditional market participants. With higher borrowing costs, we also see an opportunity to purchase non-strategic divisions from corporate sellers through carve-outs.

Olivier Maurice

Managing Partner, Syz Capital

LIQUID ALTERNATIVES

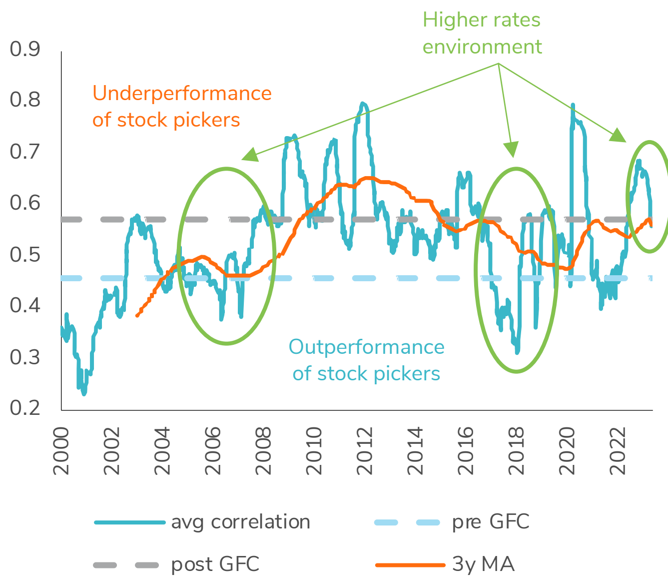
Favoured hedge fund strategies

In December, we discussed the dispersion increase in credit markets, which credit long/short managers will continue to take advantage of. In recent months, we are finally witnessing the equity market taking the same direction. As expected, a higher interest rates environment is distinguishing the good from the bad companies, providing a strong opportunity set for stock pickers and in particular systematic equity market neutral managers.

We have increased exposure to this strategy through a manager, using **machine learning**. The complexity in equity market neutral is to avoid, or at least mitigate large deleveraging shocks which occur when too many hedge funds reduce their risk at the same time. Strategies fully based on machine learning are not initially using the same assumptions than those focused on classic fundamental analysis, as they find their own logics. They therefore provide other patterns of performance, useful to diversify hedge fund portfolios.

Equity market dispersion indicator

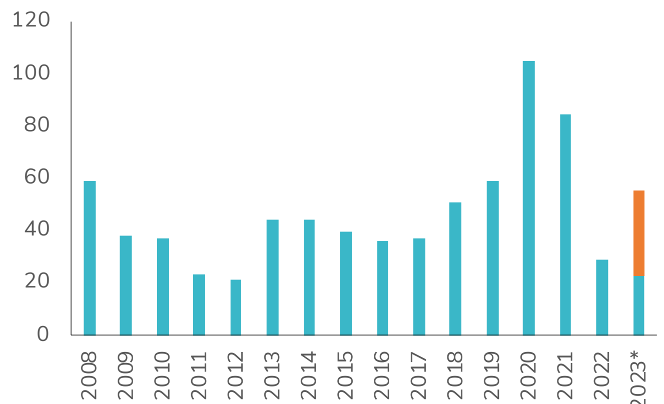
126-Day Backward Intra-Stock Correlation: S&P 500



Source: Syz Capital AG, Bloomberg, data as at 21.6.2023

The quest for alpha is a never-ending pursuit and we are constantly looking for new sources which could be triggered either by structural or macroeconomic changes. Equity market neutral using machine learning is benefitting from both, new technology and higher interest rates. We are also favorable towards another strategy that effectively capitalizes on both: **Convertible Arbitrage**. It is the second time we have a strong conviction on the strategy since the Global Financial Crisis (GFC). The last occurrence was in 2017, when we saw the resurrection of the strategy. Today, it is benefiting from an increase in new issuance thanks to a new tax law which favours the usage of convertible bonds, as well as refinancing issues that some companies are facing. From our point of view, corporations will prefer this instrument over traditional bonds to get lower financing rates otherwise unsustainable. We belive that corporate action opportunities are also accelerating for the strategy as issuers are addressing their capital structures. With the current low convertible bond prices, CFOs are taking the opportunity to negotiate refinancings before maturity despite higher rates, as they can repay their bonds early at a discount and avoid the pull to par at maturity.

New Convertible Bonds Issuance (May 2023, $ Bn)



Source: Syz Capital
* Annualised

Cédric Vuignier
Head of Liquid Alternative Managed Funds

OUT OF THE WOODS

The role of Digital Assets in Multi-Asset Portfolios

Investing in digital assets through a discretionary mandate involves at least two major decisions. The first is to consider digital assets as an investable asset class. If the answer to the first question is positive, then the next step is to select the investment vehicle(s) that meet the criteria set by the management mandate.

The Future of Digital Assets

As we witnessed in 2022, traditional diversified portfolios consisting of stocks and bonds can face challenging years. The current market environment invites investors to consider new management approaches. In a high inflation regime, the diversification properties of the bond portion are much less effective than before, as the correlation between stocks and bonds tends to be positive. What are the new options considered by investors? Gold, commodities, hedge funds, and other alternative investments (private debt, real estate, etc.) are among them. But what about digital assets?

For skeptics like Nouriel Roubini, cryptocurrencies cannot be considered investable assets. His argument is that traditional assets have cash flows (profits, dividends, coupons) or utility that can be used to determine their fundamental value. In contrast, according to Nouriel Roubini, cryptocurrencies have neither income nor utility.

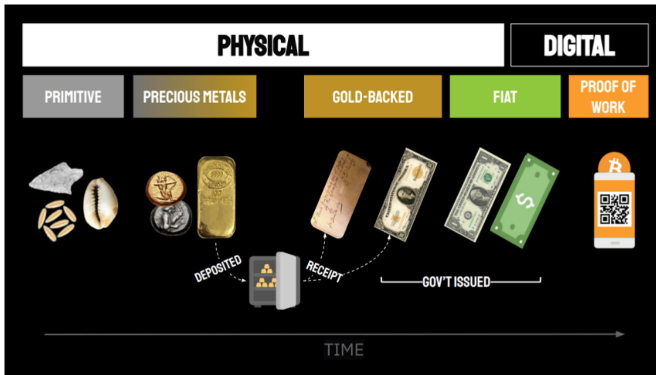
While we do not dispute most of his arguments, our perspective on digital assets is resolutely more constructive. We categorize digital assets into three groups: 1) bitcoin (as a store of value); 2) "altcoins" such as Ether, which we consider both as "liquid" venture capital and a source of high returns through staking; 3) tokenized assets, which will eventually introduce real assets (real estate, venture capital, etc.) into portfolios in the form of digital tokens.

Bitcoin: A "Superior" Store of Value

Bitcoin is neither a fraud, a scam, nor a currency for criminals. It is a technological advancement that allows the transfer of money from point A to point B on the Internet without the need for a bank or intermediary, and in an ultra-secure manner. In nearly 15 years of existence, no one has been able to attack the network and disrupt or manipulate even a single transaction.

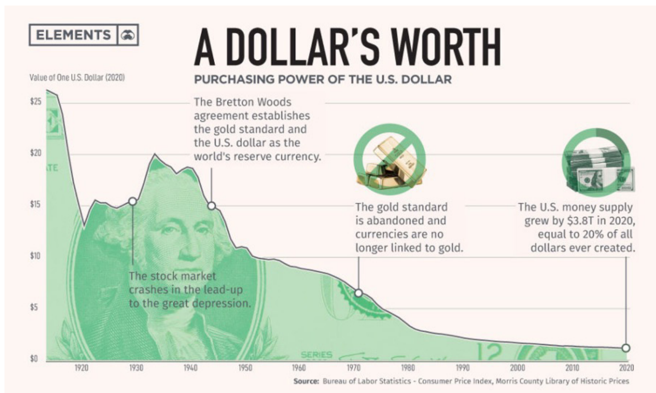
While its creator remains unknown to this day, Bitcoin has no secrets because it is an open and transparent network that can be used by everyone.

But to understand Bitcoin, one must first delve into the history of money. From primitive times until the early 1970s, there was a link between money and a scarce asset that required a certain amount of work or energy to produce. And when banknotes were introduced, they were backed by physical gold. It was only since 1971 that the link between money and an asset produced through an energy source was abruptly severed. Since then, money has been created through government debt issuance without any limit (except for the US debt ceiling, which has already been raised about a hundred times).



emerged in 2008, the year of the great financial crisis...

This forward escape by central banks has led to the continuous depreciation of so-called "fiat" currencies. The loss of purchasing power of the US dollar is not a "bug" but rather a characteristic of the "fiat" system. Indeed, this devaluation of the currency forces households to spend on goods and services or invest in risky assets rather than hoarding.



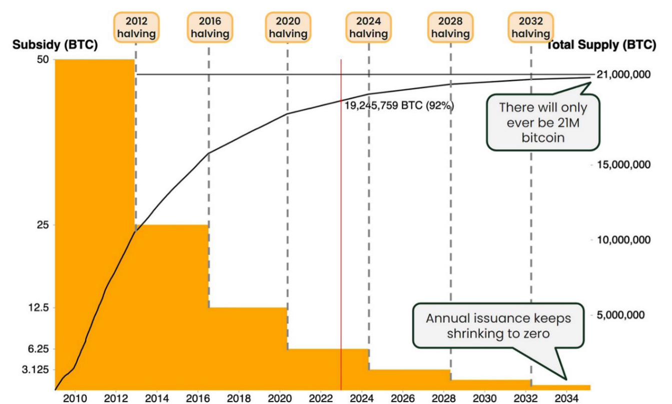
From our perspective, Bitcoin is also a store of value but with unique properties:

1) Scarcity effect: The supply of Bitcoin is limited over time (21 million by 2140). 19 million tokens have already been mined, and the production rate slows down every four years. Through an adjustment mechanism, an increase in the number of miners does not result in an increase in the supply of Bitcoin (unlike gold) but contributes to increased network security.

2) Proof of work: Bitcoin mining re-establishes a connection between the issuance of currency and the effort required.

3) Decentralization: Bitcoin is not controlled by an individual or a state but by its users worldwide through a peer-to-peer system. It is the first system that allows for a separation between the central bank and the currency. In the Middle Ages, the state and the clergy were linked because the church was the sole source of truth. The invention of the printing press changed everything because it became possible to acquire knowledge through books, facilitating the subsequent separation of the state and the clergy. Today, Bitcoin technology can enable a currency to break free from central banks.

4) Bitcoin is borderless, transferable with a click, cannot be confiscated, and is resistant to censorship.

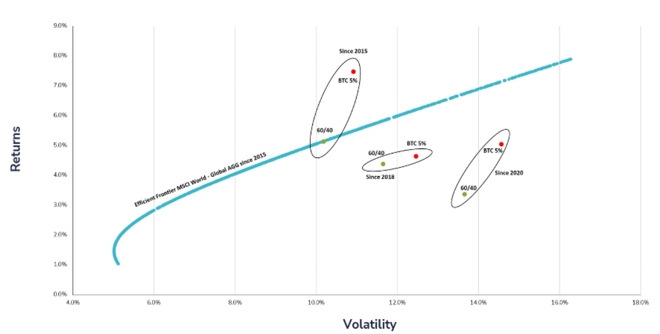


at the early stage of adoption while its supply continues to become scarcer.

In a world where the inflation rate is expected to remain relatively high, scarce assets have their place in a portfolio. It is worth noting that there are currently only 0.002 BTC per person in the world, and the number of millionaires exceeds the number of bitcoins currently available.

What about Bitcoin's diversification properties? Certainly, BTC collapsed in 2022 at the same time as stocks and bonds. However, it is important to recall the unique circumstances of 2022 (deflation of all asset bubbles) and also highlight that over longer time horizons, adding 5% of Bitcoin (rebalanced monthly) to a 60-40 portfolio has significantly improved the risk-return profile of the portfolio.

Efficient frontier: improving the risk/return profile of a 60-40 portfolio (equities/bonds) after including bitcoin, over different time periods.



Altcoins: liquid venture capital and high returns through staking

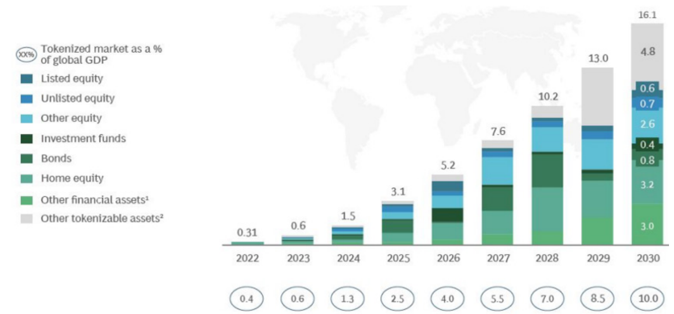
Beyond bitcoin, more than 10,000 cryptocurrencies ("altcoins") are listed in various segments: Layer1, DeFi, GameFi, NFT, etc. With the exception of stablecoins, their volatility is often higher than that of bitcoin. With the exception of stablecoins, their volatility is often higher than that of bitcoin. Many of these protocols offer very high growth prospects, but at the cost of considerable risk. This type of investment can be seen as the equivalent of venture capital, but in an "ultra-liquid" form. While it is possible to lose a lot of money in private equity, their valuation is only known once or twice a year. With altcoins, it's 24/7...

Despite Mr Roubini's claims, many altcoins do have a certain usefulness. Take ether, for example. The Ethereum blockchain enables the realization of numerous projects to which revenues (gas fees) are attached. Like many companies, it publishes results that include the revenues generated by the blockchain. In the first two weeks of May, these revenues amounted to over $270 million. It is therefore possible to calculate a price/revenue ratio for ether. It currently stands at 60x, double that of Nvidia shares, but with a much higher growth rate.

Altcoins also pay generous returns via staking, a kind of reward paid to altcoin holders who contribute to the smooth running of a blockchain. These returns generally range from 5 to 15%.

Tokenization: real assets 2.0

Blockchain offers the potential to disrupt many sectors by creating digital tokens that can represent ownership of a business or real asset through a process known as tokenization. According to the Boston Consulting Group, tokenization represents an opportunity worth almost $16 trillion by 2030 (see chart below). It will certainly be many years before tokenized assets can be included in discretionary portfolios, as the ecosystem (regulation, intermediaries, exchange platforms) is not yet complete. It should be noted, however, that Switzerland is relatively favourable to tokenization; the Swiss Code of Obligations grants tokenized assets the same rights as traditional assets via the DLT (Distributed Ledger Technology) law.



Which investment vehicle for a discretionary mandate?

Despite a favorable investment thesis on digital assets, there are many obstacles to their inclusion in a discretionary management mandate. These include

- Bitcoin's outperformance of traditional assets in the past is due to a few idiosyncratic rallies;
- Volatility can be extreme;
- The investment thesis is not easy to explain and remains controversial;
- The liquidity of many altcoins is relatively low;
- Fund managers face counterparty and custodian risks;
- It will take a few years for tokenized assets to become mainstream;
- Regulatory uncertainty remains high.

As far as regulation is concerned, let's recall the principles of SwissBanking's management mandate, which stipulates that "Investments in non-traditional investments (...) are permitted for portfolio diversification purposes, provided they are structured according to the fund-of-funds principle (...) or the multi-management principle".

As regulations evolve and volatility falls, other investment vehicles may be considered over the next few years.

Charles-Henry Monchau

Chief Investment Officer

Boring is the new sexy

Quality assets, why now? Central banks have deployed an unprecedented number of interest rate hikes in the last twelve months. Somehow, they succeeded in cooling down inflation, but at the expense of growth that is now slowing down, with an elevated likelihood of a recession in developed markets such as the U.S. and Europe. More damagingly, the brutal hikes are similar to "dynamite fishing", where first the small fish rise to the surface, for example, the Silicon Valley Bank failure. The longer the rates stay at elevated levels, the higher the chance for other fish to rise to the surface. And central banks made it clear, for now, they prioritize inflation over growth. Bottom line: be prepared for lower growth/recession, some additional unforeseen risks ("dynamite fishing") and potentially elevated rates should inflation remain sticky.

Quality is "a strong castle with a deep moat around it." Legendary investor Warren Buffet states that just as physical moats protect castles from enemies, economic moats -or sustainable competitive advantages- protect companies from competitors.

Morningstar further describes the quality fortress among 5 angles that might help weather the current environment:

1. **Switching costs:** This type of competitive advantage exists when a consumer faces significant costs in switching from one service provider to another. These costs give providers negotiating power over prices which allows them to maintain relatively high margins. Intuitive Surgical, ADP, Oracle, Stryker and Salesforce are good examples.
2. **Intangible assets:** This category includes trademarks, patents and regulatory licenses. New entrants do not have this type of competitive advantage and therefore are not able to duplicate the product or service of the first entrants. Companies such as Coca Cola, Sanofi, Johnson & Johnson and Unilever should be included in this category.
3. **Network effects:** are one of the most privileged sources of an "economic moat". The more people use a certain product or service, the more valuable the network becomes. Visa/ Mastercard, Ebay, Meta (Facebook) and Alphabet (Google) are good examples.
4. **Cost advantages:** when a company can operate at sustainably lower costs than its competitors, it has a competitive advantage that is difficult to replicate. Ikea, Shell, Amazon.com, ABInBev and Walmart are among the companies that enjoy this type of competitive advantage.
5. **Economies of scale:** oligopolistic markets are served by only a few firms. These firms generate economic benefits, but new entrants would reduce the returns to capital of the established players to a level at or below the cost of capital. The oligopoly situation protects them from new entrants. UPS, utilities and some transport companies are in oligopolistic (or monopolistic) situations and thus benefit from economies of scale.

Quality everywhere...

In equities, some call them "GRANOLAS". By 2020, investment bank Goldman Sachs had coined the acronym GRANOLAS for 11 pan-European stocks. Among them, we can find Roche Holding, ASML, Nestlé, Novartis, LVMH, or AstraZeneca. The characteristics of these stocks remain the same: strong balance sheets, strong earnings growth that is not sensitive to the economic cycle and high dividend yields.

GRANOLAS have several common characteristics. First, strong sales growth, despite their large size. LVMH's first-quarter sales rose 17% year-over-year on the back of rebounding Chinese demand. ASML expects sales growth of more than 25% this year. Most revenues are generated outside Europe, and many of these companies have dominant positions in "niches": ASML is the only company capable of producing the extreme ultraviolet lithography machines needed to write tiny features on chips. A monopolistic or oligopolistic position and a demand that often exceeds supply allow GRANOLAS to pass on any cost increases to prices. This pricing power is particularly sought after by investors in the current context of inflationary pressure. The luxury and healthcare sectors are particularly

well positioned to preserve their operating margins. These sectors are also relatively resilient during growth slowdowns and even economic recessions. GRANOLAS also offer relatively attractive dividends, with an average dividend yield of around 3%. These dividends should continue to grow over time, due to strong earnings growth, a strong balance sheet and a payout ratio of about 50%.

In fixed income, target healthy balance sheets and favor investment grade corporates due to the macro uncertainty and keep our focus on high quality corporates bonds that have proven their robustness in recession times. After an unparalleled number of rate hikes, time is required for the effects of the Fed's policy tightening to be evident. Looking to further improve quality, the "risk free" sovereign bonds now look more favorable as decorrelation has re-emerged. However, caution is advised when considering the long end, given the historical level of yield curve inversion.

In private markets, look for robustness: even though multiples have massively compressed, caution is advised. Similar to listed equities, private companies need robustness (cash-flows, steady earnings, healthy balance sheets) to navigate a potential recession. In addition, with higher rates and with the banks decreasing their appetite for lending, some small and mid sized companies might be in trouble to secure their financing. On the flip side this brings a higher risk premium for private debt holders.

In commodities, dig for gold: as we approach the end of the FED tightening cycle, gold might reach a bottom. Longer term strong support are at play: the geopolitical tensions are mounting (Taiwan, Ukrain, Opec+ and the U.S.), public debt is structurally increasing which cause major currencies to debase, and the almighty dollar is questioned.

In hedge funds, be selective: in order to benefit from market volatility, fragmentation and inefficiencies within asset classes, investors need to maintain robust selection processes to target the right strategies. For example market neutral strategies allow an investor to grasp the opportunity set without taking a bet on the market direction or without even being interested in the underlying. Today, crypto markets look similar to the financial markets back in the 80s and as such the playfield is huge for those who are able to navigate the opportunities.

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