HYPOSWISS ADVISORS

Review & Outlook July 2022

Q2 2022 Review

Stocks fall by historic dimensions and reach bear market territory

By June 30, the S&P500 Index is down 20.6% YTD, for its **largest first-half decline since 1970.** With this fall, it tumbled technically speaking into bear market territory, sinking 21.4% from its record high set early January. In Q2 2022 alone the Index fell 16.4%, its biggest one-quarter decline since the Covid-crash in March 2020. The quarterly loss for the **MSCI World** stands at 16.4%, which brings its yearly performance to -21.2% YTD.

The driving force behind the multi-year long bull-market, the **NASDAQ,** suffered its biggest quarterly drop since 2008, losing 22.5% QTD, and is down 32.2% from its all-time high set in November 2021. The underperformance of **technology stocks** since then accelerated in June 2022, as the difference between the NASDAQ Comp (-29.5% YTD) and the more defensive Dow Jones (-15.3% YTD) widened to 14.2%. The relative outperformance of

MSCI World Index in Local Currency – 01.01.2020 – 01.07.2022
Source: FIS Market Map

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the NASDAQ versus the S&P500 has been quite consistent over these years and stands at 4.9% per annum **since 2006**, delivering 115% additional value in total.

A look at different regions reveals some trends persisting in 2022 have extended, albeit with smaller differences. **Europe's** 2022 better showing continued (EURO STOXX50 –19.6% YTD), supported by the ongoing trend out of technology stocks into value stocks. The UK market remains the best in class (-2.9% YTD), thanks to its composition with value and energy stocks, which is partially also valid for Switzerland (SMI –16.3% YTD). For an **USD-based investor** however, the outperformance of Europe is more than nullified by the currency loss (EUR/USD -8.1% YTD). Therefore, if measured in USD, the European markets are still lagging.

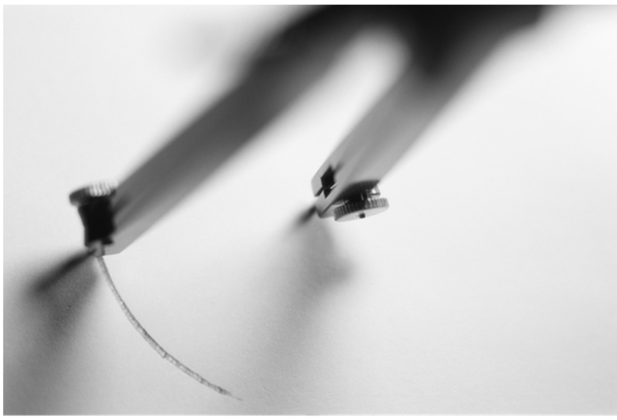
Asia is still outperforming in 2022 (MSCI Asia ex Japan -18.2% YTD). China in particular is enjoying a 'reopening comeback' (SHANGHAI Comp -7.0% YTD). The recent rally in China has widened as the reopening policy has intensified and regional investors chase the market.

Otherwise in 2022, **gold** proved its value as a hedge against falling equity markets (-1.8% YTD). This is even more remarkable if taking into account that gold traditionally moves inversely to the USD, and the **U.S. Dollar Index** (DYX) trading up strongly this year (+9.5% YTD).

Oil declined in June by 4.1%, however is still up strongly in 2022 (CRUDE WTI +46.2% YTD). At the G7 summit, the idea of capping oil prices got more attention. The concept remains difficult to grasp. The oil buyers are simply too many actors with different interests and without credible alternatives to be able to obtain price discounts.

A remarkable sell-off happened in the **industrial metal** market, taking total losses since the early March peaks to between 30% to 50%. Beyond rising recession risks and a sharp shift in the market mood from extremely bullish to increasingly bearish, the fear of an economic slowdown in China – which is by far the largest consumer of industrial metals - was the main driver for the decline.

The **USD** did continue its 2022 uptrend by advancing 2.6% towards the Euro (+8.1% YTD) and the **Swiss Franc** reached parity to the Euro following the surprise rate hike by the Swiss National Bank (SNB) in mid-June.



Equity

Equity markets struggle to find a bottom in their downtrend

The **historic losses** of equity markets in the first half of 2022 are connected to higher interest rates and inflation fears weighing on the markets. Now that we are in mid-year, the focus has shifted to **recession fears**. End of June, consumer spending for example softened the first time amid record lows in consumer sentiment.

After this heavy sell-off, the S&P500 is trading at **deeply oversold** levels. Looking at past breadth data, the last week of June was one of the most oversold weeks since 1990, as only 24 other trading days (out of 8'000 days) had fewer stocks in a short-term uptrend. Theoretically, such deep oversold levels often lead to a V-shaped recovery. However, when looking at long-term data, one can see that such low readings have a tendency to signal a volatile bottoming process before a recovery takes place. Therefore, most investors are looking for evidence that the selling pressure ebbs and the overall market breadth improves before returning to the market.

With the valuations reset already at an advanced stage, the focus now will turn towards earnings. The Q2 2022 **earnings season** is around the corner and visibility is cloudier than it has been for a while. Companies had to navigate several headwinds like ongoing supply-chain bottlenecks, rising energy prices, or the highest inflation data in decades due to the Ukraine war, just to name a few.

Analysts have lowered their Q2 earnings estimates for the S&P500 from 5.9% at the beginning of the quarter down to 4.6% to reflect the more challenging macroeconomic backdrop. One important element to watch will be **profit margins**. Consensus expects S&P500 margins to slightly increase from 12.3% last quarter to 12.4%, which seems ambitious given the continued rise in inflation alongside falling consumer sentiment indicators. The result of consumer-facing companies will provide us with a lot of information about the state of the economy.

An interesting situation is occurring in **China**, where the reopening rally has extended as policy stimulus has stepped up and regional investors chase the market on ***'FOMO'*** *("Fear of missing out')* and investors trade on 'the worst is behind us', hoping for a U-shaped recovery of the market. Chinese policy makers have also stepped up, with the introduction of subsidies for automobiles and home appliances, and several cities have rolled out more favorable housing policies, including 'housing-vouchers'.

Even global investors are returning to the Chinese market, as it is increasingly seen as a **hiding place** in the volatile global market. Furthermore, Chinese equities are trading at fairly beaten down valuations – P/E ratios of 10.9x and book value of 1.4x -, and China seems to be the only major market which is able to decouple itself from the current global correction.

Client managed accounts:

We have reduced our equity exposure in our managed accounts in the last quarter by 2% on average and have a bias towards further reductions. We refrained from so called bottom fishing as we think that markets need more time for any **bottoming process** and do not anticipate a V-shaped recovery similar to the rally after the Covid-crash back in March 2020.

One potential re-entry point is China where we have reduced our exposure last year, but still have a sizable position, and are considering to increase our exposure again in due time. We wait as new Covid-lockdowns introduced by the government are still a potential threat and we also take into account the potential geopolitical risk associated with such a move.

Markets look oversold for now and a repetition of last quarter seems unlikely as much of potential bad news is priced into equity quotations. After **our reductions**, we feel comfortable with our fairly conservative equity allocation.

Fixed Income

Interest rates fluctuate between inflation and recession fears

Last month, **short-term rates** continued their increase in line with the US Federal Reserve (Fed) rate increase of 0.75% in June to address persistently hot inflation. This increase is the biggest uptick since 1994. Long-term rates did not follow the uptrend, which results in a fairly flat yield curve from 6 months onwards; at least the curve was not inverse on June 30.

A remarkable or even **historic first half of a year** is behind us, as according to historians, US Treasuries (the safe-haven asset by definition) have seen their worst start to any given year since 1788. Translated into real figures it means negative returns of -15% at the longer end. This result is still better than the return on many other asset classes though. Hard-currency emerging market bonds have lost more than -20%, the MSCI World -21%, digital assets lost two third of their value and some emerging stocks more than -80%.

The **USD bond market** is positioning itself for **a mild recession.** The closely followed 10-year US Treasury yield declined down to 3.11% at the end of the month after a temporary high of 3.50% on June 14. The decline of government bond yields reflects the lowered expectations for Fed rate-hikes amid fresh concerns about the state of the US economy.

Back in mid-June, the bond market believed that the Fed had to raise rates beyond 4% in order to **slow the US economy.** Given the broad-based weakness in incoming data (slower private consumption, weaker housing activity or lower order inflow, among others), bond investors are now assuming that the Fed will not have to hike rates much beyond 3.25% to achieve the same result (according to Federal Fund Futures).

High prices for energy and food are keeping inflation elevated in **Europe**. The June inflation figure is 8.6% year-over-year (y/y), of which 4% can be contributed to energy, and food accounts for another 2%. This headline figures drive the political pressure on the ECB to normalize its monetary policy by lifting the deposit rate out of negative territory and to end the episode of more than **8 years of negative interest rates** in the Eurozone.

The fact that the USA did **weaponize the dollar** by freezing the currency reserves of the Bank of Russia might potentially have negative consequences for the Treasury market. In order for an asset to be **a reserve asset**, it means it has to be available when you need it. In the wake of Russia's reserves being frozen, China, India and Saudi Arabia (large buyers of Treasuries in the past) could perceive that their dollar reserves could be condemned to a similar fate and particularly the Chinese are unsure how to treat their above USD 1 trillion of US government debt.

The sheer size makes it unlikely they would be unloading their bonds quickly, but one guess is they are not renewing maturing instruments, which might create a supply / demand imbalance in the Treasury market. In April 2022 alone, **China** reduced its Treasuries by 36.2 billion, which brings its outstanding amount down to USD 1.003 trillion (according to the US Treasury Department). China is still by far the second largest foreign holder of US Treasuries (Japan holds USD 1.210 trillion).

Client managed accounts:

We reduced our **exposure** to Fixed Income (FI) by 4% this year in our managed accounts and shortened our duration as we sold some long-dated bonds and/or bond ETF's.

We were also reducing our risk within the FI-universe by switching 2% of **Emerging Market (EM)** instruments into FRN/TIPS (Floating Rate Notes and Treasury Inflation Protected Securities).

Currencies

The USD is still trending up and on course to parity versus the Euro

The **USD** extended its 2022 rally, particularly in June, when the Fed raised interest rates by 75bps. The increase was following the publication of the May CPI, which came in above expectations at 8.5% y/y, which worried the Fed enough to raise rates by 75bps rather than the 50bps which were expected by the market. Because Fed Governor Powell eased expectations of further aggressive rate hikes in his subsequent press conference, the uptick was still limited in scale.

The **Euro** will be watched upon the European Central Bank (ECB) meeting on July 21, whereby the ECB has already pre-committed itself to rise rates by 25bps, bringing the deposit to -0.25%. Europe however faces several headwinds, among other its peripheral yields (speak Italy). **Italy** has to roll over / refinance around 500 billion worth of bond redemptions over the coming two years, and other EU-members have similar needs. The potential rebuilding of the **Ukraine** and its resulting costs are yet another upcoming issue.

The **CHF**'s surged to parity to the Euro after the Swiss National Bank (SNB) surprised all market participants with a 50bps rate hike in June, the first one since 2007, reverting from unconventional expansionism to an orthodoxy policy. With this move, the SNB also dropped its determination to prevent the currency from appreciation by all means, and did formalize its tolerance for a stronger Franc. Maybe its noteworthy to remember that the EUR/CHF pair was trading at 1.68 back in 2007.

The **GBP** was suffering from UK economic data worsening and the UK CPI for May coming in at 9.1% y/y, which was the highest number in nearly 40 years. Another matter is the low-key trade war the UK government was launching versus Europe by its planned Northern Ireland protocol, which governs the trade between Northern Ireland and the British mainland, and is creating tensions with Brussels.

In June, the USD/**CAD** rose from lows of around 1.25 towards 1.30. Canada's headline CPI in May was at 7.7% y/y, well above expectations of 7.3%, and this might result in the Bank of Canada (BoC) raising rates by 75bps in July, followed by further hikes in September. The currency might suffer from oil prices not keeping their currently high levels, while its undervaluation versus the USD suggests some room to the upside.

The **Chinese Yuan CHN** traded versus the USD in a tight range between 6.65 and 6.75. The latest Chinese economic data were poor, such as PMI data, industrial production and retail sales and another counteractive factor is the sudden burden of a negative yield differential to the USD (unlike the last few years). The currency is supported short-term by the return of equity inflows following its lifting of some Covid-restrictions. On a **long-term view**, the strong current account surplus, capital inflows and the internationalization of the Renminbi will be supportive.

Economics

Can global economies avoid a recession?

Economists around the world discuss the key issue whether the Fed can achieve a proverbial soft landing or whether the USA and the rest of the global economy are spiraling towards recession. End of June however, the market consensus regarding the **probability of a recession** only stood at 35%.

Fed Chairman Powell has clearly shown his determination to slow the economy to achieve lower inflation rates. History suggests that Fed **policy tightening** more often than not results in a recession, but it matters a great deal how aggressively the monetary stimulus is being reduced. In the past 60 years, US policy tightening in the range of 300bps has usually been digested quite well by the economy, avoiding a recession, examples being the cycles of 1993-1995 or 1983-84.

Another fact is that the US **unemployment rate** is near a record low. Past figures show that the rate will rather go up than down. Once the unemployment rate starts rising, history suggest that a recession is inevitable.

In **Europe,** the ECB announced a 25bps hike for July, with the potential for a larger one in September. Market focus and the ensuing reaction was more based on the concern for peripheral spreads and what that might mean for fragmentation not only for the Eurozone but for the Euro itself. The focus is still on defeating inflation, which has gotten out of control, having been dismissed as transitory for too long (similar to the Fed's opinion).

In addition, Europe is struggling with the impact of the Ukraine war, the resulting long-term supply constraints. **Gas shortages** next winter could even lead to an implementation of rationing energy, which further impacts the inflation scenario.

China's economy suffers from the 'triple threat' of renewed Covid lockdowns, a shift of global demand away from manufactured goods towards services and a floundering property market.

Commodities

Russian oil exports are almost at pre-war levels and Russian revenues even higher

Oil prices oscillated rangebound between USD 110 to 120 per barrel in June, staying shy of the peaks reached in March. The price reaction to geopolitical news flow suggests that the market still embeds a high degree of uncertainty, meaning a **risk premium.**

Earlier fears about a substantial supply loss, as buying **Russian oil** was viewed negatively, proved unfounded. The West's self-sanctioning caused a momentous rerouting of a key artery of the oil market. Russian oil tankers no longer sail to nearby European ports but take the longer routes into Asia, namely to China and India. Initially the re-routing caused some hiccups in terms of establishing new trade partnership, finding suitable ships and getting insurance, but now activities seem to settle in a new phase and frictions are decreasing.

Russian oil exports are almost at pre-March levels. Traders of Russian oil are simply leaving Europe and setting up new offices in the Middle East. Helped by higher oil prices and with delivering the same volumes, **Russian revenues** from oil are higher than before the war. The new setup is becoming stable as Asian insurers are replacing European companies, helped by government-backed schemes, both out of the reach of western sanctions.

The latest release of the official **US oil market** statistics shows that the production in the USA is growing, as the high oil prices are a gusher for the shale business and demand is slowing as high fuel prices make households more conscious of driving.

On the **long-term horizon,** the currently high oil prices are fundamentally not justified and will not be sustainable, the emerge of e-automobiles being one reason.

Gold has done the job by holding its value

Gold has held up remarkably well this year, amidst very poor returns for standard asset classes, the S&P 500 trading -20% and the 10-year Treasury –14%. **Copper**, usually a barometer for commodity prices, is off by 20% from its peak, despite a supply-driven bull market in many resources from grains to energy.

It is even more remarkable as **traditional tailwinds** for the precious metal are now opposing forces. For example, gold trends with falling real rates, but the 10-year TIPS-yield has rebounded violently as the Fed has turned more hawkish. Gold also moves inversely to the USD, but the dollar index is up strongly this year.

The shiny metal is also a great **inflation hedge**, a fact that dates back many centuries, given that it has been a monetary standard. The pre-war period in the early 1900s saw a tremendously undervaluation in gold, as an economic boom was met with a rigid money supply. It was not until the 1929 stock market crash followed by the Great Depression that Western governments had to debase fiat money versus gold to stop price deflation.

Another matter is the freeze of **Russia's USD reserves**. Anticipating this move, Putin began selling Russia's Treasuries after he annexed Crimea in 2014, and started to buy gold and since then Russian gold holdings have tripled to 22% of its total reserves. As trust between some countries is eroded, gold might become the ultimate reserve asset (despite cryptos' claims to be another candidate). Currently, gold as percentage of total central bank reserves remain low, with India holding only 8% and Saudi Arabia or China standing at 4%.

On a more **short-term view**, gold is expected to trade sideways and to follow the move of interest rates, as global central banks fall behind the curve in fighting inflation. Once it becomes clear that inflation has peaked, either via a soft landing or an outright recession, gold will lag industrial commodities.

Client managed accounts:

We hold our long-term strategic position of 5% gold as an insurance against all possible **geopolitical negative events** as we are seeing in the Ukraine, potential conflicts like a China-Taiwan confrontation or a further acceleration of inflation. Furthermore, gold has held up relatively well during **equity market downturns** as we are witnessing right now.

Gold prices (XAU ounces) in USD – 01.01.2020 – 01.07.2022
Source: FIS Market Map

Outlook

Recession fears dominate making market sentiment bearish

Going forward, equity investors might take some comfort in the fact that the magnitude of losses at this pace rarely take place in **two successive quarters.** This is not to say that further losses should not be anticipated.

Coming into the second half of the year, markets have to deal with **different large risks.** The biggest concern is an upcoming USA and global **recession.** Market consensus is increasingly going in the direction of not whether the USA will avoid a recession, but more if this will be a brief recession of a few months or a more prolonged contraction of activity. Other items are a prolonged **slow Chinese growth** in connection with their Zero-Covid policy plus **European gas shortages** resulting from Russian oil-supply coming to an end.

The market no longer seems too much worried about **inflation,** as measures of longer-term inflation expectations continue to decline, indicating that investors believe that the Fed will succeed in getting it under control. Interestingly, some past headaches seem rapidly forgotten. The **Ukraine** war is still front news, nevertheless it has no sizeable impact on markets as long as the current stalemate continues. The **Covid** situation is still a worry for China, but the rest of the world has come to terms with the virus.

One can argue that after the recent declines, a major slowdown is already **priced into** risk assets. Yet given the crash in sentiment, investors will need more patience before markets can rebound sustainably. The next item to be watched is the **Q2 earnings season,** which will be about margin squeezing and pricing power. It will provide an indication of how corporations have been dealing with the tricky circumstances and their forward-looking expectations will give further clues. It is unlikely though that it will allow the market to rebound as a whole and will only lift certain single stocks with outstanding results.

We **enter the second half of 2022** with a cautious approach and think it is too early to be brave. We have a reduced weighting in equites as we judge that global equity markets will remain fragile and need time for their bottoming process and we watch China as one potential re-entry candidate. We keep mainly short-dated bonds for capital preservation and continue to hold gold for unforeseen events. We increasingly like Alternative Investments as an important tool to diversify portfolios.

Walter Küng
Senior Portfolio Manager

Remark:

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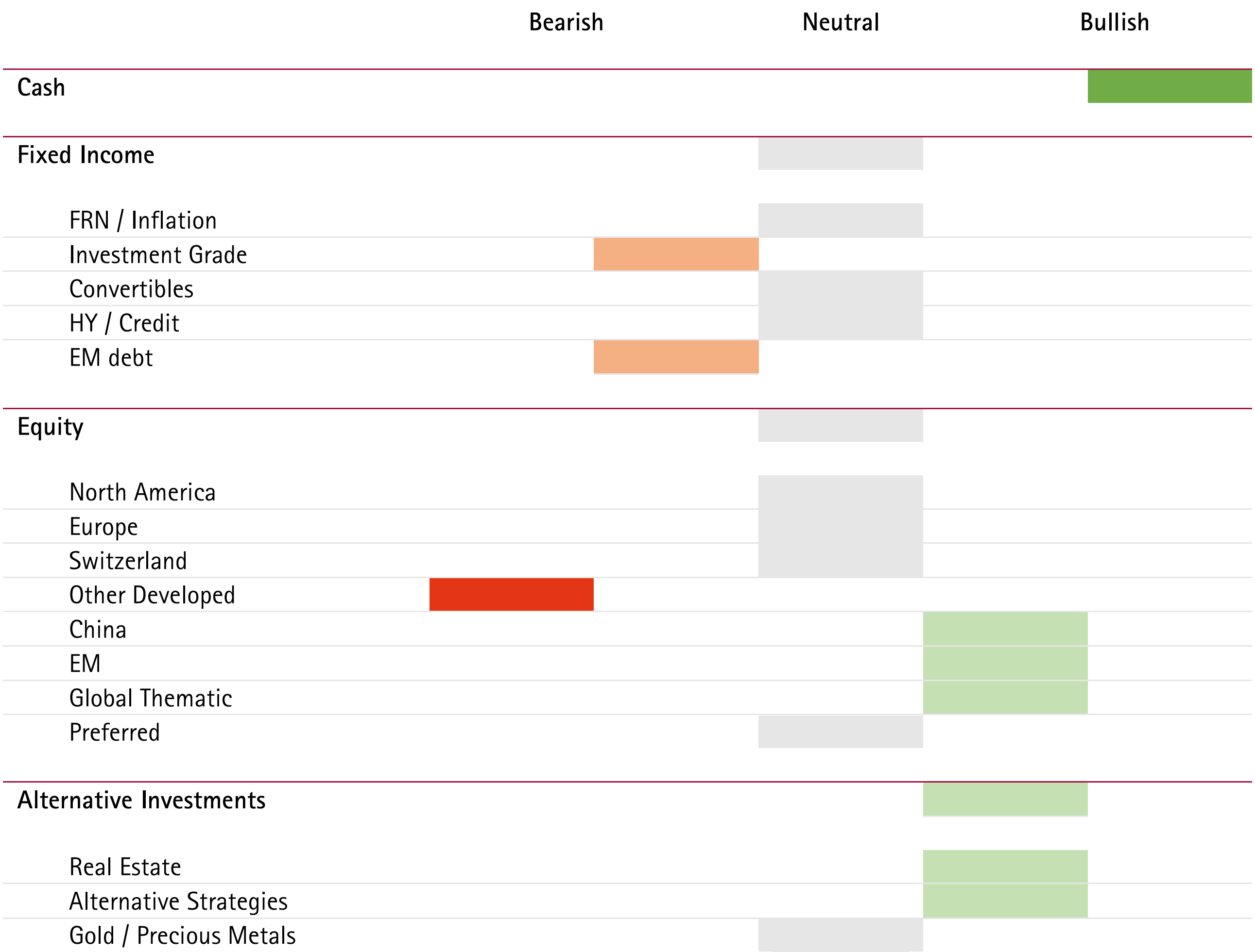
For any question or doubt, please contact your Relationship Manager that will review your account and provide personalized comments and information.

Asset Allocation

USD Reference – Balanced



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- Hyposwiss Advisors' mission is to offer **personalized asset management services and financial advice** to high net worth individuals and families based in the **USA** and **Canada** with the overriding objective of **capital preservation** and **asset growth** performance oriented.

- Investments in compliant global assets are used to construct a **diversified balanced portfolio** tailored to the investor's requirements and deposited with **international banks** acting as qualified custodians.

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