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Review & Outlook
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Hyposwiss Advisors SA

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Q3 2022 Review

All asset classes losing by historic dimensions

Global stocks had their worst month in September since the 'Covid-19-crash' back in March 2020 and posted their 3rd straight quarter of losses for the first time since 2009. The **S&P500** lost astounding -8.65% in September alone, resulting in a yearly performance of -24.77%. The **MSCI World** declined similarly by -8.70%, which is reducing its performance to -26.40% YTD.

By this drop, global stocks have erased over USD 30 trillion (in numbers: USD 30'000'000'000'000) in value since their peak early 2022. This represents the **largest destruction** of value in the history of financial markets. Another look at historic numbers reveals that in the last 96 years, the S&P500 only experienced 3 worse years, which were 1931 (Great Depression), 1974 (bad recession) and 2002 (war in Iraq on the horizon). Now in **2022**, we have not yet encountered a global recession, but markets must digest an upcoming one.

MSCI World Index in Local Currency – 01.01.2020 – 30.09.2022
Source: FIS Market Map

We also have skyrocketing inflation data coupled with a tremendous increase in USD interest rates and finally, almost looming in the background, we must cope with a war with a nuclear superpower involved.

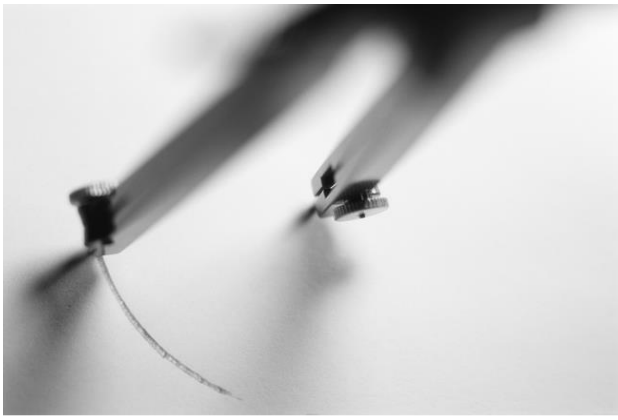
The US Federal Reserve (Fed) raised **interest rates** for the third consecutive meeting in September, bringing them to a target range of 3% to 3.25%. Most central banks, with the notable exception of the Bank of Japan (BoJ), increased their rates in various degrees, but all to a lesser extent than the Fed, which increases their interest rate differential to the USD.

Finally, the USA **30-year mortgage rate** rose for the first time above 7% since the year 2000. The last 1% rise was the fastest in history, as it took less than one month! The effects of the Fed's new stance were also felt at the **real estate market**, as average prices for single-homes with mortgages fell by 0.6% month-on-month, the first monthly decline since March 2020 and the largest since 2011.

The **USD** was continuing its run by advancing 3.08% in September (US Dollar Index +17.12% YTD). The Euro (which represents 57% of the US Dollar index) is not even the worst performer with a drop of -2.51% MTD (EUR/USD -13.79% YTD). Other major currencies lost even more, like the British Pound with its -4.51% drop in September (-17.99% YTD), and the terrible performance for Japan's Yen with -4.03 MTD (-25.62% YTD).

Oil shed nearly 25% to post its first quarterly loss in more than 2 years. At one point, the year-to-date gain was above 70%, at the end of September, it stood at +7.87% YTD (Crude WTI). At that time, markets were betting that OPEC+ would cut crude output by 1million barrels a day at their October 5 meeting to staunch the oil price slide.

Otherwise in September 2022, **gold** dropped -2.62% MTD and below the USD1'700 line. It was briefly bouncing on the news of troop mobilization in Russia, but the USA monetary policy is far more important and is giving the metal a rough time.



Equity

Equity markets break through support levels – where is the bottom?

At the end of September, the S&P500 fell below its **June low** of 3'630, likewise the Nasdaq to 11'040. The break of these support levels is technically seen a bad sign and strengthens the persisting downward trend and increases the risk of reaching the old support levels derived from the pre-Covid-19 highs, which are at 3'394 for the S&P500 and 9'737 for the Nasdaq. On the other hand, markets are heavily **oversold** measured by many indicators, such as the gap between the index and the 50-day moving average. A recovery rally is therefore overdue and there are signs that we are moving towards the later stage of the cyclical bear market.

Up until now, most of the year-to-date decline can be attributed to a **normalization** in interest rates. The end of financial repression is painful, especially for the highly valued segments of the equity market (growth stocks) that came under even higher pressure. One could argue that the largest part of the interest-rate normalization is behind us. The US 1-year Treasury has risen within twelve months by an astonishing 391 basis points (bps) and the 10-year Treasury by 223 bps and it seems extremely unlikely that this uptick will be repeated going forward, particularly within such a short time frame.

In the past, the second and next phase is a readjustment in **company's growth expectations** and along with it the associated earnings per share (EPS). The upcoming earnings season and the outlook given by companies will give further guidance.

A look at different regions reveals the following:

Europe's showing in 2022 (EURO STOXX50 –23.72% YTD) is almost exactly the same as the S&P500 (-23.62% YTD), despite all the negative news in connection with the European energy crisis. If one takes the decline of the Euro (-13.79% YTD) towards the USD into account, the picture looks completely changed and Europe is underperforming the USA like in the preceding years.

The **UK** market is still outperforming the rest of Europe (FTSE 100 -6.81% YTD), even if one includes the negative performance of the British Pound into the calculation, as the decline of GBP/EUR is only -4.98% YTD.

Asia is slightly underperforming world markets in 2022 (MSCI Asia ex Japan -27.55% YTD). The relentless plunge in **China's** stocks has burnished the appeal of its biggest rivel India, spurring a divergence. In the last quarter, the MSCI India beat the China index by the most since the year 2000.

The **Hang Seng Index** of Hong Kong declined -13.88% MTD (-26.55% YTD) and by this drop is back at the highs of the late 1990s. Thus, there was zero capital gain to be achieved in this region in more than 20 years and one could argue if this means that we are at the bottom of this market or that one should ignore this market altogether as it seems incapable to deliver any positive results at all.

To **summarize,** we think that global markets are at a late stage of their bottoming process, and currently oversold. But the break of the June lows is a bad sign and opens the road to further declines, as markets tend to overshoot on their way up but similarly on their way down. In addition, while the increase of interest rates is largely priced into stock valuations, the upcoming recession with the resulting lower corporate earnings is not yet fully taken into all quotations.

Client managed accounts:

We have reduced our **equity exposure** in our managed accounts in the last quarter, particularly in Europe, and have a bias towards further reductions. We want to keep a certain level of equity allocation though, as we judge that in times of high inflation, stocks of quality companies prove to be a good investment. Furthermore, we consider the current depressed sentiment which includes some elements of panic as not a good time to sell.

Fixed Income

Global central banks are rising interest rates to fight inflation

In the last quarter, the Fed raised its target rate three consecutive times amid a **general hawkish attitude**, with the desired result **that all rates continued** their stubborn increase almost in line, the long-term rates however moving up with a lesser degree. The resulting yield curve at the end of Q3 was **inverse** at different maturities, particularly as the 2-year rate at 4.12% was higher than long-term maturities. This situation could be signaling a recession ahead.

In **Europe**, tensions are high after the Eurozone's annual inflation rate rose from 9.1% in August to 10.0% in September (only preliminary numbers, market expectations were 9.7%), reaching double digits for the first time. This is the fifth consecutive month of rising inflation, with prices showing no sign of peaking, as pressures have spread from energy to many other items (particularly food at 11.8%). Germany recorded the highest inflation rate (10.9%) and France the lowest (6.2%).

Christine Lagarde said that the **European Central Bank** (ECB) will consider shrinking its balance sheet only once it has completed the 'normalization' of interest rates. She was also 'officially' apologizing for the rise in inflation by saying: "I am not challenging that we made some projection errors" and that the ECB must continue to raise rates to curb inflation, even if this leads to a slowdown in growth. She added that the first objective of the rate hikes was to reach a neutral rate which neither stimulates nor hinders growth.

At the end of September, the International Monetary Fund (IMF) criticized **Britain**'s new fiscal plans of large tax cuts and big increases in public spending. A spokesperson said it was not recommending such fiscal measures at this stage as the fiscal policy should not run counter monetary policy. The Bank of England (BoE) decided to hit back and thereafter announced that it would make temporary purchases of long-term UK government bonds, to restore orderly market conditions.

Client managed accounts:

We reduced our **exposure** to Fixed Income (FI) in the first half of 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.

In September, we took advantage of the lower bond prices to buy some short-dated bonds which have a low interest rate risk and stayed within the Investment Grade (IG) universe. Even after these purchases, we have a **high underweight** in this asset class.

Going forward and considering that central banks on both sides of the Atlantic will most likely hike interest rates again in 2022, we wait for further additions just yet.

Currencies

The USD is winning against all other currencies and is king for now

The **USD** extended its 2022 rally, profiting from further interest rates advantages and a general prevailing risk aversion, as the greenback currently is the most dominant safe-haven currency. Other fundamentals like relative price trend and terms of trade remain favorable, nullifying past overvaluation and are enabling the strength to proceed short-term. In the long-term, easing on the risk front and fading rate advantages could cause the USD to soften, but for now, the dollar is king.

The **Euro** is held back by general risk aversion and the high costs of crucial imports, above all energy and other raw materials. The ECB's willingness to normalize its monetary policy is a tailwind for the euro that will intensify during the course off 2023, when the ECB will catch up somewhat with its peers. In the long-term, the erosion of price stability and the loss of foreign trade surpluses are another burden, next to political instability in the European heterogenous landscape.

The **CHF** was crossing the 1:1 parity level to the Euro in July, when the Swiss National Bank (SNB) decided to end a seven-year phase of a negative interest-rate policy. By this unexpected move, it was accepting a stronger currency and was also refusing to pre-commit its policy leaving all future options open.

In the long-term, the CHF will continue to profit from price stability in Switzerland (2022 expected inflation rate of 3.2%) and its low gross public debt (in 2021, 28% of GDP), in times where most countries have readings of above 100%.

The **GBP** was suffering as currency markets sanctioned the Truss government's unfunded growth plan that put fiscal stability at risk. The Bank of England (BoE) may provide stability, but the GBP trades with a markdown until confidence is restored. The budget details to be presented in November could calm fears of fiscal imbalances, next to the size of the interest rate hike on the BoE meeting on November 3.

In **Canada**, the Bank of Canada (BoC) proceeded with hiking its policy rate rapidly with another 75 bps to 3.25% in September, holding pace with the Fed. However, risk aversion and receding energy and commodity prices prevent the CAD from keeping up with the USD. In the long-term, an attractive undervaluation and rising rates are positive elements for the risk-sensitive Loonie, which will as in the past follow the development of commodity prices.

The **Chinese Yuan CHN** weakened to a 14-year low of 7.26 at the end of September but later recouped some losses. If one compares the CHN against a global basket of currencies though, it has remained relatively stable, unlike during the period of serious Covid-19 outbreaks in April this year. The drop against the USD is connected to the ongoing global risk-off sentiment and to the fact that China's 10-year bond yield is presently 106bps below the USD 10-year treasury, while it was higher the last few years.

The uncertain Covid-19 situation, the ongoing downturn in the property sector and weaker exports due to recessions in developed economies are all negative factors keeping the currency at fragile levels

Economics

The USA is still going stubbornly strong – Europe is heading into recession

The signs of a global slowdown are mounting, as indicated by the flash **Purchasing Managers' Indices** for September (a PMI reading above 50 indicates an expansion, below 50 a contradiction). Europe, in particular, is struggling in both manufacturing (48.4) and services (48.8) and some countries such as Germany or Italy will see a recession of yet unknow size. The USA manufacturing sector (52) still reported solid growth. Eye-catching is the worsening slump in China's manufacturing activity (48.1), which is the main reason for the weak emerging market (EM) aggregate (49.4).

The fact that the **US economy** has not yet succumbed to recession, as so many were predicting in spring, provides some preliminary support for the view that the 'choke point' for interest rate is quite high. Notable the **labor market** remains very strong. Presently there are nearly two job openings for every unemployed worker. The September labor market report (unemployment rate 3.5% / expected 3.7%, among others) suggests that the US economy is so far able to weather the current headwinds from the tighter financial condition and higher inflation rates that are weighing on disposable income and still serves as an important stabilizer for the economic growth outlook.

Europe is suffering as its largest economy Germany's bad run continues. **Germany** factory orders were reported to have fallen by 2.4% in August, lagging the previous month by 1.9% and market forecasts of only a 0.7% decline. This is the sharpest contradiction since March, amid weak demand, persistent high inflation, and supply chain problems. Furthermore, the German government now expects to slip into recession next year, with a contraction of 0.4%, due to the energy crisis among others.

Commodities

Oil countries almost at war with the West

OPEC+ announced a **production cut** of 2Mb/d (2million barrels per day) at their meeting on October 5 in Vienna, starting from November and extended its alliance with Russia until end-2023. While this cut represents only 2% of global supply, it is still much higher than markets had expected (1Mb/d) and is the largest one since the steep cut at the outset of the Covid-19 pandemic. This move demonstrates that OPEC+ is back in the driver seat aiming to set a Brent floor of about USD 90 and prevent any further material drop in the price.

This production cut has turned into a politically fiery affair as the US government has publicly expressed is dissatisfaction and could trigger **US countermeasures**, including the additional releases from its Strategic Petroleum Reserve (SPR) and the increase of US domestic oil production and even a restriction of oil exports. It is also being reported that the Biden administration might ease oil sanctions in Venezuela.

The decision seems more determined by the geopolitical environment and power games than fundamental conditions and many see it as a **hostile bid against the West**. Several OPEC members are already pumping far below their official quotas and the upcoming European oil embargo on Russia later this year is producing another uncertainty. The tensions between the oil consumers in the west and the producers are set to increase with China as an oil consumer torn in the middle of the opponents.

At the same time, the European Union (EU) is reportedly planning to move ahead with the price cap on **Russian oil** proposed by G7, although the details of such a plan have not been revealed yet. The consensus among industry specialists is that such a price cap would have unintended consequences leading to higher oil prices. Russia's Prime Minister Alexander Novak reiterated his warning that Russia will not sell oil to any country that adopts such a cap.

Maybe it is also worth remembering that the USA has **shrinking options** to respond to the Saudi-Russian oil output cuts via further releases from its SPR. US President Joe Biden has taken already 850'000 barrels per day since June with the result that the Reserve has reached its lowest level in 40 years (415million barrels), well below its typical pre Covid-19 standard of roughly 700 million.

Another outcome of the OPEC+ agreement to chop oil supply was that **commodities** roared into the fourth quarter in some style, with prices set for the best weekly showing since March. This was particularly true for the **industrial metal** market. It was also reacting strongly to reports that the London Metal Exchange (LME, the world's most established metal exchange) could reconsider the eligibility of Russian supplies, and industrial metal spiked at the end of September, led by **aluminum**. There was an element of short covering by speculative traders who wanted to take advantage of the bearish market mood. It remains to be seen if this uptrend marked the lows or even signals the starting point of a longer-lasting metals rally.

Gold also is a victim of monetary policy

All that seem to matter for gold is the **US monetary policy** which resulted in a stronger USD and higher bond yields, which both pushed metal prices lower. The war in the Ukraine has moved out of focus as the war's economic and financial market implications seem to be contained for now. The war though remains a wildcard and a source of uncertainty.

The market mood in September was extremely bearish for gold and led the price to fall as low as USD1614. It was even triggering **safe-haven seekers** (which are desperately looking for alternatives to equities) to sell their gold holdings, as the metal does not seem able to withstand the general downtrend of prices in the traditional asset classes.

Gold managed to cross the USD1700 level again at the beginning of October and even marked its biggest daily gain since March (+2,4%). Weak US manufacturing data damped bets on the Fed's hawkishness and led to a sharp decline in treasuries which boosted the appetite for the non-yielding precious metal.

The **high-inflation period** of the 1980's is not a good guide for today's gold market. Back then, the market was still finding its balance after the collapse of the Bretton Woods system and monetary policy had just entered a new era. That said, in the 1980's gold prices peaked well ahead of inflation and they were down around 40% at the time of the highest inflation rates.

Client managed accounts:

We hold our long-term strategic position of 5% gold as an insurance against possible **negative geopolitical events** as we are witnessing with Ukraine, potential conflicts like a China-Taiwan confrontation, not to mention a nuclear escalation from Russia. Furthermore, gold has held up relatively well during the 2022 equity market downturn, particularly for non-USD investors.

Gold prices (XAU ounces) in USD – 01.01.2020 – 30.09.2022
Source: FIS Market Map

Outlook

Markets are obsessed with the Fed's policy – pessimism prevails

The **status quo** is that global equity markets have lost by historic dimensions, bond yields are rising exceptionally and therefore bond prices are falling accordingly, currencies other than the USD are tanking and gold offers some hedge, but an unloved one. Inflation is moving up by numbers not seen for years, a recession seems inevitable, and a certain panic is shooting through the roof. The question is whether **a capitulation-like washout** is needed before a recovery sets in.

The current **depressed sentiment** seems to leave little room for optimism. Maybe some market participants have jumped to early to certain conclusions: The **consensus view** is that equity market react negatively every time the Fed moves away from monetary easing. The last time the Fed started to raise rates was in 2018 and financial markets went down 20% thereafter, until the Fed reversed its course just a few month later. Then in 2020, the Fed injected massive liquidity into the system to fight the Covid-19 related economic downturn and financial markets despite an economic decline and to the surprise of many surged to new all-time highs. Now in **2022,** the Fed is raising rates again and markets fall by historic dimensions, following the path of recent years.

Nevertheless, history has shown that a rise or fall in rates does not necessarily correlate with a similar rise and fall in equity markets, as for example the **1980's** have shown. However, today markets seem to follow the Fed's interest rate policy step by step, and of course, markets are (almost) always right.

The upcoming **earnings season** and the forward guidance of each company will bring some light to the future direction of the market. It is looking for S&P500 Q3 earnings to increase by 2.9%, down from 9.8% expected at the start of the quarter. Expected bottom-up EPS fell from USD 59.4 to USD 55.5, representing a 6.6% decline over the course of the quarter. The big themes could be the strong USD, resilient pricing power, economic normalization, benign credit, inventory clearings, longer deal cycles in tech, housing sector slowdown, labor market constraints and easing supply chain issues.

The **US midterm elections** on November 8 will be another event that markets will follow closely. The outcome will most likely be a gridlock in either a split Congress, with Republicans winning back the House of Representatives but Democrats retaining control of the Senate, or a Republican sweep. In both cases, the election outcome should have marginal economic and limited market impact.

The usual **seasonal pattern** in mid-term election years - such as 2022 - is that markets tend to bottom in early October. It would also be in line with typical bear-market patterns, where stocks tend to retest the lows established earlier, and it would be in accordance with investor sentiment undercutting the lows made during the pandemic in March 2020.

We **enter the last quarter of 2022** with a very cautious approach and think it is still too early to put new money into equities despite their depressed levels. We accommodate a more or less neutral weighting in equites as we judge that global equity markets need time for their bottoming process. We increasingly keep short-dated bonds for capital preservation and to generate interest-income and continue to hold gold for unforeseen events.

Walter Küng
Senior Portfolio Manager

Remark:

"Client managed accounts" refers to a generic description of general investments for managed accounts under discretionary mandates. Each account and portfolio could be materially different from this description and could invest or not in substantially different securities or products, based on individual risks and objectives. The descriptions above are not meant to reflect exact holdings by all accounts. Non-discretionary mandates could also be managed in a manner materially different than the description above.

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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- 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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