HYPOSWISS
ADVISORS

Review & Outlook
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Hyposwiss Advisors SA

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Q1 2023 Review

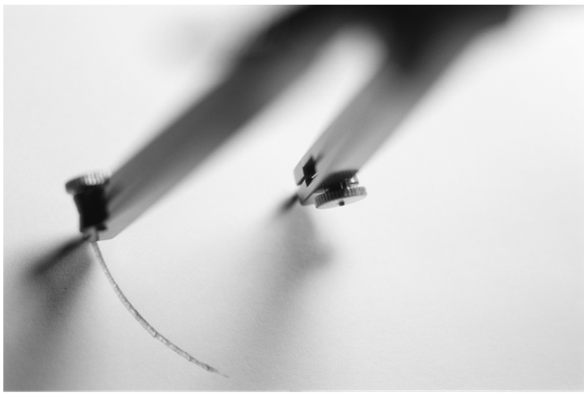
Inflation, Central Banks and Financial Stress

The first quarter of 2023 was packed with economic, financial and markets surprises.

On the economic front, data released in Q1 pointed to resilient economic activity and a very disappointing inflation picture. The resilience in economic activity is remarkable given the accumulated monetary tightening. This global economic resilience can be attributed to a combination of strong US labor markets, the effects of the Chinese reopening and a short-term better energy supply situation in Europe than feared for the winter of 2022/23. For the longer term, structural vulnerabilities remain in the European energy security. As to the negative surprise on the inflation front, the situation in the US where headline CPI is running at 6% year on year, down from a peak of 9.1% in the middle of last year, reflects mainly sticky services prices. We are not overly concerned there, as we think the disinflation trend is well established, despite taking more time than expected. In Europe, the core inflation rate currently stands at 6.55% and has yet to show signs of a convincing peak.

iShares Global Financials ETF (red) vs MSCI World Index UDS (black) – 01.04.2022 – 31.03.2023
Source: FIS Market Map

Central banks, unsurprisingly, pursued their tightening campaign. The target for Fed funds rose to 4.75- 5% from 4.25-4.5% at the beginning of the year and Euro rates (deposit facility at the ECB) increased to 3% from 2%. In Switzerland as well, the Swiss National bank increased rates to 1.5%. Japan was the only exception in developed economies, leaving rates at zero and maintaining the framework of yield curve control for longer maturities.

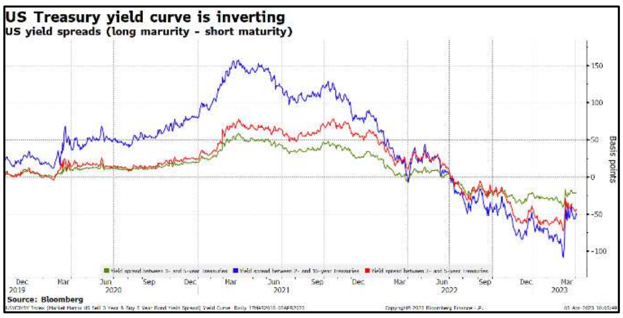


In March, this environment was upended by the failure of two regional banks in the US and the shotgun marriage of Credit Suisse to UBS by Swiss authorities over a weekend (at a heavy cost for some subordinated bondholders and for shareholders). Each situation has different roots, but we have learned one thing: the fast monetary policy tightening cycle witnessed over the past 15 months has created large financial imbalances, some of which are coming to fore.

In the US, deposits are leaving the smaller banks in favor of larger institutions and money market funds. This can lead to a liquidity/solvency problem when these deposits have been funding purchases of longer dated low yielding bonds on banks' balance sheet (as these bonds can be accounted for at cost on the financial statements and selling them leads to the recognition of a loss). In Europe, the cost of capital for banks is rising as a direct consequence of the turmoil in bank subordinated instruments. We expect these developments to lead to an ongoing tightening of credit conditions and availability. Forecasting the magnitude of the impact this will have on economic activity is "guesswork", as stated recently by the Fed Chairman, but the direction is undoubtedly towards dampening economic activity.

Additional areas of stress could appear. One area to watch is the commercial real estate market, particularly the office segment. This segment is exposed to structural change (the work from home trend), requires very significant refinancing over the next few years and in the United States regional banks play an outsized role in its funding.

These financial stresses produced a large impact on rates: Real 10-year yields moved from 1.75% to 1.25%, 2-year notes rallied from a top of 5% yield all the way down to 3.75% and the curve dis-inverted massively (from -100 to -40 on the 2-10 years spread). The risk premium on hybrid and financials bonds increased, but overall credit spreads (investment grade or high yield) remained well behaved.



In clients' portfolios, we have reduced risk exposure during the quarter in by selling out of Real Estate assets and by exiting the more volatile credit exposures. These positions were replaced with more stable Infrastructure assets and higher-grade credits.

In adopting a 12–18-month investment horizon, we can make the following statements:

- The interest rate cycle in the US is probably close to its peak. The hit to growth from the credit channels will act as a substitute to monetary policy. Even though the extent of this substitution is uncertain, it is hard to see the Fed tightening much further when financial stability might be at stake.
- Any slowdown or recession arising through a credit squeeze would be more concerning than a pure "rates "recession, as it could create negative feedback loops that would be more difficult to counter through traditional monetary policy measures. The risks of recession have increased, but this is not our baseline scenario.
- When inflation finally declines, we expect that rate cuts will become possible, and the Federal Reserve is likely to lead the movement.

Going forward, we will be emphasizing the following points in our investment policy.

Fixed Income

In Fixed Income:

- Reducing credit and subordination risk in favor government bonds
- Continuing to take advantage of carry in the short or intermediate investment grade credit markets
- Maintaining exposure to real yield instruments and initiating exposure to intermediate government bonds to prepare for the possibility of rate cuts late in 2023 or early 2024.

Equity

In Equities:

- Overweighting the quality growth segment of equities markets and being very selective in the cyclical/value allocation. In general, we want to hold companies positioned in growth markets, are not too sensitive to the economic cycle and whose valuation can benefit from lower rates.
- Despite its short-term sensitivity to economic activity, we are holding on to our broad energy equities allocation.

In our thematic allocation, we have reviewed the principles governing the allocation within a portfolio context and established the following guidelines

1. The thematic allocation is complementary to the core equity allocation.

2. The themes selected are expected to benefit from clearly identifiable long-term drivers of

return. We want to be positioned to benefit from multiyear trends of topline growth derived from structural forces

3. The investable universe is to be comprised of profitable companies which have demonstrated an ability to monetize this growth

4. The valuation at the entry point must be appropriately related to the investment thesis.

5. The themes should be broad enough to allow for active management of the opportunity set

On this basis the Investment Committee has concluded that the three following themes are to be included in portfolios:

- **Health Care**, as it is positioned to benefit from aging population, increase of access of the emerging market middle class and a sustainable innovation trend in many therapeutic areas. We recognize that the sector is periodically threatened by regulations and therefore highlight the necessity to manage this risk actively. We are mostly interested in the following 3 subsectors: biopharmaceuticals, Health care services and medical devices. These sub sectors offer a diversified opportunity set, benefit from multiyear tailwinds for top line growth, have seen multiple innovations that will be monetized and are currently reasonably valued. In addition, they are all beneficiaries from digitalization and the adoption of artificial intelligence.
- **Energy** and energy transition related assets: The energy transition is a huge undertaking which will lead to massive investments over a very long horizon. The precise positioning will vary over time and will include traditional energy assets, renewable energy assets, electric and gas utilities, transportation and infrastructure related assets, climate transition enablers, select commodity producers.
- **Digitalization** beneficiaries: The trend towards digitalization has not yet matured but is evolving. We will strive to benefit from sub themes that have a long growth runway ahead of them, such as: cloud adoption, software as a service, artificial intelligence integrators, cybersecurity providers, mobile payments, and networks. In this theme in particular the challenge will be to stick to a valuation discipline.

Commodities

Our commodities allocation has been negatively impacted over the quarterly the increased risks of recession. We are holding on to this position on the view that commodity assets will benefit from years of underinvestment and from the needs associated with the energy transition.

Currencies and Precious Metals

We are advocating running low currency risks in portfolios. Positions in gold are expected to continue to benefit from lower bond yields and are maintained.

As always, we will be attentive to incoming data. We will be looking with particular interest at spot inflation data released monthly, at the ISM indices and their inflation subcomponents, at the behavior of corporate margins as the earnings season progresses and at bank lending surveys to evaluate the functioning of the credit channels.

Daniel Jakobovits
Head of Investments

Gold prices (XAU ounces) in USD – 01.04.2022 – 31.03.2023
Source: FIS Market Map

Mission Statement

- 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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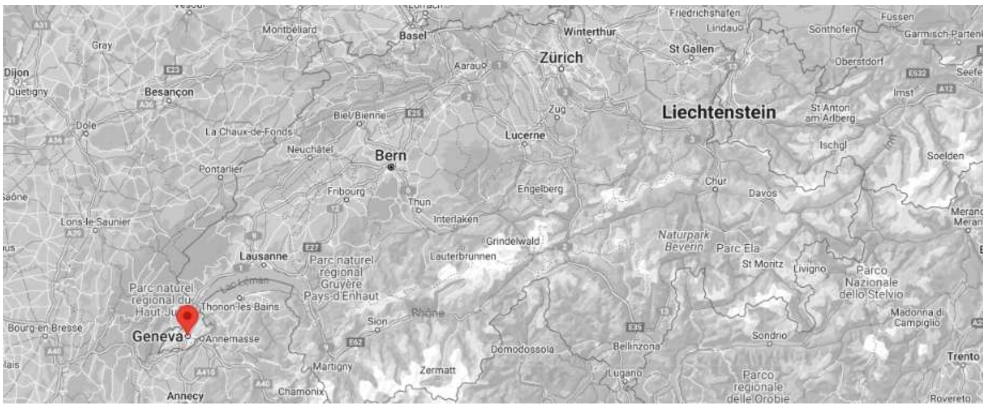

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