Letter n°63

Should we fear a further decline in the financial markets?

"The optimist loves the uncertainty surrounding the future"
Nietzche

A Nasdaq up 20% between 16 June and mid-August, an S&P 500 index up 17% over the same period, commodities down significantly by more than 20% since June, volatile 10-year rates and the economic outlook outlined in Letter 62, all illustrate the premature optimism of the markets. Certainly, Nietzsche is right and the wise investor will be cautious in the short term.

In this Letter 63, we will analyze the different asset classes, commodities, interest rates, currencies and stock markets, and we will support our recommendations.

Commodities:

Fossil fuels still account for 80% of energy demand and, whether the advocates of the energy transition like it or not, this is unfortunately not going to go down and many stocks in the sector will still appreciate.

- ***The prospect of a recovery in oil prices***:

From $70/barrel in 2019, the price of Brent had fallen to around $15 in the midst of the Covid crisis. After the invasion of Ukraine, it reached nearly $135/barrel and today it hovers around $100/barrel.

This is due to the slowdown in global growth and, above all, the 10% year-on-year decline in Chinese demand in July. Also, the IEA (International Energy Agency) has revised downwards its expectations for global demand in 2022 to 99.7Mb/d.

This slowdown in demand should be temporary because in 2023, consumption could reach 101.8Mb/d, a level close to capacity, and even 102.7Mb/d, according to OPEC.

In view of an expected recession that is neither long-lasting nor deep, in view of the 9% year-on-year decrease in world oil reserves, in view of producers' reluctance to invest and the modest amount of unused capacity, prices should recover in the coming months, after the easing observed since mid-June.

To complete this obscure picture of production capacity, let's add a few points:

While US crude production reached 12.1Mb/d in June, its highest level since Covid, new shale oil fields in the US are less productive.

OPEC's available capacity, according to the organization, would have fallen to 1.7Mb/d. Saudi Arabia is supposed to be able to increase its production to 12Mb/d, but recently it was extracting 10.5Mb/d, less than its quota of 10.6Mb/d. Russian production is also 1.5Mb/d below its quota and production from Nigeria, Libya and Angola is also below their targets.

- ***The growth in coal consumption***:

Notwithstanding the pollution caused, notwithstanding greenhouse gas emissions double those of gas, coal is more than ever the 2nd largest source of energy in the world, after oil, with 27% of the energy balance.

In response to increased consumption, production increased in Indonesia, Australia, China and other regions, but this has not prevented the price, $417/tonne in Australia, from more than doubling since the beginning of the invasion of Ukraine. Apart from the increase in demand, this price appreciation is also the result of the increase in freight prices in Europe caused by the lack of water on the Rhine and the limitation of ship loading.

- ***Soaring gas and electricity prices:***

Russian gas, in 2021, was nearly 40% of the gas consumed in Europe and substitution must therefore be organized. Gas consumption is expected to fall slightly worldwide in 2022 but the price of gas has increased tenfold since 2019 and each closure for "maintenance" of Nord Stream I causes a sharp rise in prices reflecting the tensions in this market.

Liquefied gas is growing and the winners are to be found in the United States, Australia, Qatar, Norway and Algeria.

The rise in electricity prices, a nearly tenfold increase since 2019, weakens alternative electricity suppliers, unable to maintain the attractive rates charged before the crisis and therefore we will not invest in these companies.

- ***The temporary drop in metal prices***:

For the past 4 months, there has been a one-quarter decline in the price of copper because Chinese demand, 40 to 50% of global demand, is affected by the slowdown in economic growth.

But copper consumption is expected to increase by 7% in 2022-2023, above the average of 2.5% observed since 2010 and this trend is set to continue in the coming years.

So, sooner or later, prices will recover and stocks will benefit.

The same is true for other metals, aluminum, zinc and cobalt, which are falling due to fears of a recession. But, let's not forget that companies have invested little in recent years and unused production capacity is minimal.

- ***Easing of cereal prices***

According to the US Department of Agriculture (USDA), despite the drought, global cereal production is expected to increase in 2022, +8MT to 779MT, as Russia, Australia (+3MT), China (+3MT) and Canada (+1MT) have increased production.

Since the peak on 16 May at €438/tonne, wheat prices have fallen to €322, the pre-invasion level. A year ago, however, the price of wheat was €200/tonne and it is too early to be reassured.

The same goes for maize (Russia and Ukraine 20% of world trade) with a price of $6/bushel after a high of $7.8 in mid-May because supply is, more than wheat, affected by drought.

Let us mention fertilizers, with a word of caution on companies in this sector, because the increase in the price of fertilizers, made from potash, phosphate or nitrogen, is forcing many farmers to reduce their consumption.

Interest rates: ***caution maintained***.

In response to inflation, central banks around the world, with the exception of China, Russia and Turkey, have stepped up rate hikes, stopped injecting liquidity, and have sometimes started to reduce their balance sheets.

In this context, after the upturn of the last few weeks, we maintain our advice of extreme caution as volatility will persist. As evidenced by the 30-year mortgage rate which was at 3.2% at the beginning of the year, 5.8% in June, 5% at the beginning of August and 5.55% today!

In order to better understand the situation, let's remember a few points:

- ***Sustained above-target inflation***:

Central bankers were wrong about inflation expectations. In almost two years, consumer price inflation in Europe will have exceeded the cumulative increase of the last ten years and, according to the IMF, inflation is expected to be 6.6% in developed countries in 2022 and 9.5% on average in emerging countries.

With regard to the outlook for inflation, the easing of the prices of many commodities could have a positive impact on inflation rates, but in Europe the almost tenfold increase in gas and electricity prices will have an impact on production costs in industry and penalize household purchasing power.

Another point to remember is that when the headline inflation falls, the cost, a little more than 2% of GDP, will still be borne by households and businesses, if prices stabilize at high levels and do not fall.

Faced with the risk of a recession, some central banks, aware that fiscal policy can no longer be activated, worried about the level of debt, 3.5x world GDP, and a worsening of defaults, will hesitate to raise their rates too much and will tolerate inflation above 2% for some time but this is not yet the tone of the speeches of central bankers.

- ***Rising rates***:

According to the IMF, over one year, 75 of the 100 major central banks have raised their rates, on average by 3 points for emerging countries and 1.7 points for developed countries. As a result of these movements, never in American history and never in Germany since 1984, have we seen a bond performance so negative.

Since July, an 8% recovery in high-yield bonds has been observed. At the end of June, they were at 8.95% in the United States, 7.45% in mid-August and the spread over government bonds has fallen from 6 to 4.25%, but this improvement was short-lived.

- ***The end of liquidity injections in many central banks***:

In 2007, no central bank balance sheet exceeded 22% of GDP. At the end of 2021, the SNB's balance sheet reached 150% of GDP, that of the Bank of Japan 135%, the ECB 65%, the Bank of England 45%, the Fed 42%, and the Bank of China 40%.

This development was the consequence of liquidity injections. They were initiated in 2001 by Japan, became widespread during the financial crisis of 2008 and increased significantly during the health crisis.

In the last two years, to help get out of the Covid crisis, the Fed has acquired $3.3 trillion of public debt and $1.3 trillion of real estate debt and thus holds a quarter of public debt and a third of real estate debt. The other major central banks have done the same.

The ECB and the Bank of England each hold 40% of their governments' public debt, the Bank of Japan owns 50% of Japan's public debt.

Unfortunately, these injections have often not benefited credit and have led to bubbles in the financial markets.

- ***Caution on high-yield bonds***:

The market is bad, volatile and should be approached with caution. Since the beginning of the year, the yield on US high yield bonds has almost doubled from 3.7% to 7.2%. If the economy falls into recession, the spread over government bonds is expected to widen further as the currently low default rate could deteriorate.

Overall, corporate debt is $12.2 trillion including $6.7 trillion in bonds, often at fixed rates, $1.2 trillion in bank loans, $1.1 trillion in mortgage debt and $3 trillion in loans by non-bank financial institutions. Of this total, high-yield bonds represent $1.8 trillion, of which only $75 billion mature in 2022/2023. Companies have some $4 trillion in cash and after-tax margins of 18%, a level not seen since 1945 but, according to Moody's, the default rate could rise from 2.1% to 3.3% within one year and would still be below the historical average of 4.4%.

- ***FED***: ***a measured determination***.

Since 1970, the Fed has increased rates five times by one point and four times by 0.75%. The two recent increases of 0.75% to 2.25/2.50% and the next one expected on 21 September, possibly again by 0.75%, are therefore exceptional but are necessary even if the inflation rate monitored by the Fed, the PCE index, fell to 6.3% in July against 6.8% in June, the "core" index also fell from 4.8% to 4.6% and the producer price index (PPI) fell from 11.3% to 9.8%.

Short-term rates could thus exceed 3.5% at the end of 2022 but then start to be lowered before the end of 2023 if the country enters a recession.

The Fed is playing for credibility and Powell, at Jackson Hall, has defended a firm line. From September onwards, the Fed will reduce its balance sheet by $95 billion/month, i.e. $60 billion in government debt and $35 billion in real estate debt. This is twice the amount of the policy initiated between 2017 and 2019, which caused a drop in the stock market at the end of 2018. According to the Fed, a $2.5 trillion contraction of its balance sheet would be equivalent to half a point increase in rates, but at the current rate of liquidity tightening, it will take eight years to return to the 2008 balance sheet, which is too slow.

The 10-year rate, after having fallen, has risen in recent days to 3.10%, causing the stock market to fall, and the yield curve is inverted with a spread of 0.32%.

- ***ECB***: ***vigilance towards the most indebted countries***.

The Commission anticipates inflation to reach 7.6% for the year with a peak of 8.4%, but inflation has already exceeded 10% in the Baltic countries. It is impossible not to react to the resurgence of inflation but impossible to risk a new monetary crisis as in 2011.

On 21 July, the increase in the key rate of 0.50% made it possible to erase the negative rates. It was the first rate hike since 2011, which had caused a debt crisis and forced the ECB to back down.

The rate hike will continue at each of the next central bank meetings and rates could reach 1.2% at the end of the year.

Anxious to avoid a "replay" of the 2011 crisis, the central bank has put in place an instrument against market fragmentation with potentially unlimited purchases of public debt in fragile countries, Italy and Greece, if they meet the Brussels criteria. In June and July, the ECB's purchases of Italian and Greek public debt amounted to €17 billion while German, Dutch and French debt relief reached €18 billion.

The Germany-Italy spread has risen to 2.35% but remains far from the 5% of 2012. In Italy, although the country can boast a current account surplus of 2.5% of GDP, the political crisis is deep, the country has to manage a high public debt at 150% of GDP and, in the run-up to the elections, investment in Italian bonds will be avoided. In Greece, after GDP growth of 8.3% in 2021, inflation in June reached 12.1%, pushing the 10-year rate to 3.51%.

Faced with the prospect of an economic slowdown, German 10-year yields, after a high of 1.75% in June, fell to 0.80% in August before rising to 1.36% in recent days. Given such volatility in quality securities, we will choose to be cautious.

Outside the Eurozone, inflation in Poland stood at 15.5% in July, so we will stay away.

- ***Bank of England***: ***the insufficient rate hike***.

With inflation at 10.1% in July, the highest in 40 years, and the prospect of inflation at nearly 13.5% by the end of the year, or even higher at 18% according to Citibank's forecasts, the rise in rates from 0.50% to 1.75% is certainly the largest increase since 1995 but it is notoriously insufficient even if the bank foresees a recession at the end of 2022.

The rise in rates, 1.1 percentage points since the beginning of the year, is less than the United States rate rise to 2.25 percentage points and therefore the £ is weakening.

- ***Bank of Japan**: **monetary policy unchanged***.

Inflation is still moderate at 2.4% in July excluding food.

The maintenance of rates at -0.10% has forced the Central Bank to intervene much more heavily than previously, recently 10.9 trillion Yen on average over a five-day period compared to 4 trillion Yen on average over five-day periods between 2015 and 2021.

- ***Swiss National Bank***: ***determination against inflation***.

The inflation rate is at 3.4% in July, lower than the US and European rates because monetary stimulus has been less since Covid.

This inflation differential offers a competitive edge to Swiss exports, but the SNB is nevertheless determined to bring inflation down.

- ***Bank of China***: ***the slowness in rate cut***.

A further rate cut in mid-August by 0.1% to 2.75% and a new injection of nearly $60 billion, made necessary by the weak economy, are possible due to low inflation at 2.7% in July but the approach is delicate because the Central Bank fears capital outflows to the US dollar.

- ***Bank of Russia***:

The Central Bank lowered rates from 9.5% to 8% despite inflation at 15.9% in June.

- ***Other Asian countries***:

Inflation is alarming, 45% in May in Sri Lanka, 23% in Laos, 21% in Pakistan, and it will force these countries to further hike rates.

Rate hikes are also expected in Thailand because inflation is at 7.6%, in South Korea because inflation is at 6%, and in the Philippines because inflation is at 6.1% in June.

Currencies: ***unusual fluctuations***.

- ***US Dollar*:**

Over the last 40 years, the $ has recorded 4 phases of appreciation, the first in 1985 following the Volcker policy, the second in 2001 after the Asian crisis and the Russian crisis, the third in 2008 during the financial crisis, the fourth today because the FED's tightening policy and the rise in the prices of various commodities are benefiting the United States.

- ***Euro***:

The € is at 0.99, the lowest in recent years. The Euro accounts for 24% of central bank assets compared to 60% for the $ and is almost at the lowest in 20 years after a 12.5% decline since the beginning of the year. This depreciation is explained by fears of recession in Europe, even if the Commission anticipates growth of 1.4% in 2023, a lower rate hike than in the United States, 50 basis points against 225 basis points, and a deterioration in the European trade surplus.

- ***Pound Sterling*: *caution maintained***.

It has depreciated by 12.6% this year against the $ and is stable against the €. A further decline is expected as the country enters a recession and this could slow down the Central Bank in raising rates.

- ***Swiss Franc*: *buying maintained***.

The SNB, worried about inflation at 3.4% and in a context of low unemployment rate at 2%, raised rates before the ECB and seems to accept the appreciation of the Swiss Franc as an instrument to fight against imported inflation. The € was thus at 1.04 before the rate hike, it is now at 0.96 and this trend corroborates the safe-haven status of the Swiss Franc.

- ***Asian currencies*: *resistance***.

While the Yen has fallen by 18.9% this year and the Indian Rupee by 7% (as foreign exchange reserves have fallen by nearly $35 billion due to the worsening current account deficit), the currencies of Southeast Asia, Singapore and Indonesia, have held up better against the $ than the € because monetary policies have been tighter.

- ***Yen***:

Inflation at 2.4% in June and 1% "core" reinforces the Central Bank in its policy of injecting liquidity and maintaining the key rate at -0.10%, at a time of decline in industrial production and slowdown in retail sales. Nevertheless, after the sharp depreciation, a recovery of the currency against $ has been observed recently.

- ***Yuan***: ***caution***.

It has depreciated by nearly 8% against the US dollar this year and is expected to fall further as the Central Bank will continue to lower rates to support the economy.

- ***Gold**: **possibility of a rebound***.

A traditional safe haven, gold is suffering from rising rates because it does not offer yield but can remain a diversification in portfolios, if only because central bank purchases continue. At $1745/ounce, gold is down 17% from the high but is expected to appreciate.

- ***Bitcoin and Cryptos***:

Bitcoin rose 28% in July and has been falling since with no discernible trend in its outlook. The capitalization of Bitcoin remains moderate relative to gold, $500 billion against more than $10 trillion.

Stock markets:

The recovery of the S&P 500 between early July and mid-August was 17% and that of the Nasdaq 20%, but since then a correction has begun.

The stock market decline may go through two phases, the first, already observed, initiated by the rise in rates, the second with the decline in corporate results expected in the second half of the year. Beyond this period, financial markets often perform well in recessionary phases because they anticipate a recovery sooner or later.

Since the beginning of the year, there has been a decline in global capitalization and less liquidity:

- ***Decline in global capitalization***:

Market capitalization had lost $25 trillion from 1 January to 23 June. This decline was the worst first half since the early 70s. The recovery, like the previous ones, has been rapid but it cannot be linear.

In an inflationary context, companies that can pass on cost increases should be favored, and in a context of rising rates, companies with low debt should be favored.

While in recent months, the focus has been on "value" stocks such as private utility companies in an inflationary environment. Companies such as EDF, which are state-owned and subject to government subsidies, will be ruled out in this sector. We will remain positioned on healthcare stocks. We will wait for more visibility on the economic situation before returning to cyclicals, which have been abandoned for the time being.

The catalysts for a market recovery are lower inflation, better visibility on the extent of the slowdown, a halt to restrictive monetary policies, and a resumption of growth in China.

- ***Decreased liquidity***:

This is noticeable in IPOs, SPACs and mergers and acquisitions.

The fall in IPOs is pronounced. In the first half of the year, the number of IPOs worldwide fell sharply from 1171 in the first half of 2021 to 630 according to E&Y, and they raised only $95 billion against $225 billion.

At the end of June, only 70 SPACs went public compared to more than 600 in the first half of 2021 and they raised only $12 billion against more than $80 billion in the same period last year.

M&A deals, according to Refinitiv, fell by more than 20% in the first half of the year worldwide and there does not seem to be any improvement in the second half.

- ***The US market remains unavoidable***:

The United States accounts for 66% of global capitalization, compared to 69% at the end of 2021, and is home to 59 of the world's top 100 companies. Technology stocks account for a third of the capitalization of the top 100 groups, or $10 trillion, compared to 37% at the beginning of the year and 15% 10 years ago.

The main exceptions to the decline in the first half of the year were stocks related to commodities, oil exploration and production like Occidental at +100%, fertilizers like Mosaic Co at +20%, grain traders like Archer Daniels Midland co at +15%.

Conversely, Micron Tecnologies Inc, Nvidia and Intel have reported a less dynamic semiconductor market as demand for laptops declines and this is confirmed by statements from Dell Technologies and HP.

- ***The European market benefited from the depreciation of the € but was the most affected by the energy crisis***:

After a 9% gain between the July lows and the mid-August peak, European equities, penalized by recession fears, lost most of their gain.

The depreciation of the € benefits the energy, aeronautics, luxury and tourism sectors. We observed a good performance in luxury, especially LVMH because, despite China, operating income grew by 34% in the first half of the year. The same goes for Kering with an operating profit up 26% despite the lockdown in China. In the aviation sector, traffic has recovered to 70% of its pre-Covid level and the improvement is expected to continue.

The European market is not expensive but the possibility of an interruption of gas supplies by Moscow is an unknown which, according to the IMF, could cost Germany 3 points of GDP, the main economy of the Eurozone, and therefore penalize the market again.

- ***The Chinese market is affected by difficulties in reviving the economy***:

China accounts for only 10% of global capitalization and has 13 of the world's top 100 companies, but the slowdown in its economy, both cyclical and structural, is worrying.

The P/E is low at 12x/13x, so tempting, but concerns persist about the economy and the new stimulus package, mainly in infrastructure, of $145 billion, or less than 0.8% of GDP, added to the previous $44 billion plan, will probably not be enough. More interesting, for the valuation of the Chinese market, is the compromise negotiated with the Americans to preserve the listing of Chinese companies in the US.

Conclusion: ***"Times are short to the one who thinks, and interminable to the one who desires" Alain.***

- In this year of market decline, -14% for the S&P 500, the EuroStoxx (in €) and the Swiss market, -22% for the Nasdaq, -17% for the Chinese market, this word from the great philosopher Alain makes the link between client expectations and the investment strategy implemented.

- One conviction, often reaffirmed in these Letters, is that the liquidity of a portfolio is a key to management. Who, at the beginning of the year, could have predicted the war and its consequences on the markets? It is important to be able, if necessary, to reorient a portfolio and this is impossible with private equity funds.

- Clearly, not all sectors of the economy are affected equally by this crisis born of the invasion of Ukraine. The energy sector, +37% worldwide this year, is the big beneficiary, while sectors whose profitability is dependent on energy costs, chemicals and plastics for example, are among the losers. We can add technology stocks, -20%, consumer discretionary, -21%, after a very good performance during the lockdowns, and real estate, -16%, as a victim of the rise in rates.

- This umpteenth crisis reinforces our choice not to touch private equity and to avoid hedge funds with quarterly or semi-annual liquidity. Investing in private equity is not under mandate management and is a risky long-term investment.

- On the other hand, we continue to prefer equities or equity funds to other asset classes, we remain reticent and selective on bonds, we maintain exposure to different sub-sectors of energy and commodities, we are positioned on sustainable growth stocks while trying to avoid those that take advantage of exceptional circumstances (Netflix -61% this year, Meta -50%...) or outdated cycles (Nvidia -39% this year...). We also keep defensive stocks in healthcare for example or so-called "value" companies. We are waiting for more visibility on the economy before returning to cyclicals, which have been abandoned for the time being.

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