SINGALLIANCE

Letter n°82

Mid-year review, from the expected to the unexpected.

"To say what is as it is," a principle of ***Herodotus.***

Let us apply this principle of Herodotus and ask ourselves what to think of the evolution of the markets during the first half of the year?

At first glance, the performance of many asset classes is somewhat the inverse reflection of those in 2022, but let's distinguish between markets:

- ***From the stock market perspective***

Following the decline of global stock markets in 2022 by 19.5%, and specifically the decline of growth stocks by 30%, there has been a significant recovery. Growth stocks have increased by 21%, the S&P 500 has risen by over 15%, the EuroStoxx by over 16%, the Nikkei by 29%, and the Nasdaq by 31%. Despite these impressive figures, the performance is actually deceptive because 80% of the appreciation in the US market is attributed to seven stocks, while others have shown performances often close to zero or negative.

- ***From a sectoral perspective***

In contrast to the strong performance of energy stocks in 2022, up by 30.7% due to an increase in oil prices by 10.4%, as well as gas and coal prices, we can observe substantial corrections since the beginning of the year. European gas prices have fallen by a factor of 11 compared to their peak in 2022, electricity prices in Europe have decreased by a factor of 7, coal prices have dropped by more than 2.5 times, and Brent oil prices have declined by 12%. Overall, taking into account metals, the 13.7% appreciation of commodities in 2022 has been corrected by over 9% in the first half.

- ***From a currency perspective***

After the appreciation of the $ against all currencies in 2022, by 12% against the Yen, 10.7% against the £, 7.8% against the Yuan, and 4.6% against the €, there followed a period of erosion for the $. It weakened primarily against the Brazilian Real (-9%), the £ (-4.8%), and also the CHF (-2.8%). In fact, only the Yen and the Yuan continued to experience significant depreciation, with the Yen down by an additional 10.4% due to the continued monetary policy of liquidity injections in Japan, and the Yuan down by 5% as the Chinese central bank lowers its rates while the Fed raises its own.

- ***From a bond market perspective***

The worst performance in bond markets since the early 1970s, with a decline of 16% to 17% for high-yield bonds or investment-grade bonds, was followed in the first half by a bumpy and ultimately modest recovery of 1.7% to 2% for the same bonds. Paradoxically, the best performance, 10% in the United States, was seen in the riskiest category of bonds, the CCC-rated bonds of the most heavily indebted companies, which cannot be recommended due to their highly speculative nature.

In summary, unless one has bet on a few stocks with stellar performance, the performance of portfolios and funds is often more modest. However, to understand these developments, we must distinguish between the expected (first part) and the unexpected (second part).

The expected:

A certain but slow disinflation:

- Disinflation favoured by various factors:

Inflation rates peaked in 2022 at 10.6% in the Eurozone and 9.1% in the United States but have since been declining.

The easing of supply bottlenecks was the first factor of disinflation, followed by the decline in energy prices as the second factor, and more recently, the third factor, the decrease in food prices. The price of Brent crude oil was $120 a barrel a year ago and is now at $75.5. The price of gas in Europe peaked at €340/MWh in August 2022 and has fallen to one-tenth of that at €34/MWh. The price of wheat, which reached a high of €340/tonne in 2022, has fallen to €228.

- The downward rigidity of "core" inflation:

According to the latest figures, the inflation rate is still at 5.5% in the Eurozone and 8.7% in Great Britain. The "core" inflation rate excluding energy exceeded 5% in these countries and even reached 7.1% in Great Britain, far from the 2% target set by central banks or even the 3% desired by some economists like Olivier Blanchard, former Chief Economist of the IMF.

The downward rigidity of "core" inflation is due to labour shortages in many sectors, with 10 million in the United States and 0.5 million in Great Britain, and unemployment rates at 3.7% in the United States and 6.5% in Europe, the lowest in the past two decades. In many non-competitive sectors, companies' behaviour is also a contributing factor as they aim to preserve their profit margins.

- Further rate hikes by the end of this year:

Since 2022, we have already seen 13 interest rate hikes in Great Britain and 10 in the United States. Expectations include a 0.50% increase in the United States, spread across two hikes starting from the current rate of 5-5.25%, a 0.75-point increase in the Eurozone added to the current rate of 3.5%, and a 1-point increase in Great Britain added to the current rate of 5.7%.

- Possible consequence of these rate hikes:

A recession, a slowdown in investment, and an increase in the unemployment rate. In the United States, some studies suggest that it would take an unemployment rate of 6.5%, equivalent to an additional 5 million unemployed individuals, to lower the inflation rate to 2%. Is it worth taking this risk? Is it not possible to tolerate temporarily higher inflation?

Another possible consequence is the vulnerability of the real estate sector, particularly in Great Britain, due to short loan durations and frequent renegotiations. This would impact property prices and reduce purchasing power for British households.

However, the real estate market, except for notable exceptions such as US commercial real estate sensitive to regional bank difficulties, does not exhibit the same weaknesses as in 2008 because inventory levels are low.

For bond portfolios, the early-year recovery in bond markets did not withstand the tightening of monetary policies.

Avoiding a recession in developed economies:

- What about the inversion of the yield curve?

The sharp inversion of the yield curve in the United States, by 1.1 percentage points, and in Europe (0.8 percentage points in Germany) is traditionally seen as a sign of an impending recession. However, this is not the case at present.

- The evolution of the economic situation:

The undeniable slowdown, or even contraction, in manufacturing activity in recent months, observed across the globe through manufacturing PMI indices below 50, is offset by continued positive demand in the services sector. This is crucial because in developed economies, the weight of the industry, ranging from 10% to 20% of GDP, is lower than that of services, which accounts for around 80% of GDP. For example, in the United States, only 14% of jobs are in the manufacturing sector, with 9% in manufacturing production.

The unexpected:

The weakness of China's recovery:

- Structural difficulties:

Aware of the structural difficulties in the Chinese economy, the impossibility of returning to the double-digit growth rates seen for about three decades, conscious of the depth of the real estate crisis, concerned about the debt of local governments and state-owned enterprises, and worried about demographic decline, major asset managers had nevertheless made a tactical call on the Chinese market, betting on a temporary rebound. However, they have not been successful so far.

In the long term, everyone remembered China's vigorous fiscal stimulus of 13% of GDP during the 2008 crisis, and everyone could believe in measures, whether fiscal or monetary, to ensure a way out of the long Covid crisis in China.

In the short term, everyone kept in mind the weakness of the support measures during the Covid period, a policy that was the opposite of that in the United States, as the Trump and Biden administrations injected the equivalent of 18% of GDP to prevent the risk of recession, while China had done very little.

- The weakness of the economic recovery:

From the exit of the Covid crisis, one could have expected a strong rebound in private consumption, boost for investment, and support measures to overcome the real estate crisis.

But six months later, nothing significant has been seen other than half-hearted measures, minimal interest rate cuts of only ten basis points, and a relaxation of capital requirements for real estate acquisitions.

Nothing has been done to instil confidence, boost consumption, or stimulate investment.

Like in Japan in the 1990s, the burst of the real estate bubble is affecting the financial situation of households, penalizing their consumption, which is already low at 38% of GDP compared to an average of 55% in major countries.

But that's not all as urban youth unemployment, with over 20% of them unemployed, is also a hindrance to consumption.

- Stock market performance:

In summary, the worst performing stock indices as of 30 June are those in China. This is particularly disappointing as the decline of the CSI 300 index, since its peak on 10 February 2021, has reached 30%, while the S&P 500 has appreciated by 14%.

The decline in oil prices and many commodities:

Last year was exceptional for this sector, just as it had been dreadful for growth stocks. This year, the performances have reversed for each of these themes. Energy, the only major sector that saw an increase in 2022, is performing the worst this year. On the other hand, the tech sector, which was the worst-performing sector in 2022 (-35% worldwide), is now the brightest sector with a +39% gain.

The reasons behind this include the weak recovery in Chinese demand and the lack of consensus within OPEC+ between Saudi Arabia and its major partners. Saudi Arabia, the second-largest global producer after the United

States, is reducing its production from 1 million barrels per day to just over 9 million barrels per day in order to maximize its revenue. However, Russia, the third-largest global producer, has tried to sell as much as possible, even at discounted prices. Meanwhile, the UAE has obtained an increase in its production quotas.

Another reason for the price decline is the increase of over 2 million barrels per day in non-OPEC production this year, especially in Norway, the United States, Brazil, and Canada. These countries are capable of easily meeting the growth in global demand, estimated at 102.3 million barrels per day according to the IEA.

Recent news includes Russia's announcement of a decrease in its exports by 0.5 million barrels per day starting in August. If implemented, such a measure could push prices higher. However, the markets remain sceptical for now.

The polarization of stock market appreciation in AI and luxury:

We can discern four trends from the evolution of the equity markets in the first half:

- The outperformance of AI:

At the end of 2022, after a 33% decline in the Nasdaq and a significant correction in growth stocks, a rebound could be anticipated. However, there was no reason to bet on a 30% rise in the Nasdaq in six months, let alone to focus on the seven largest companies responsible for 80% of this appreciation.

Apart from the AI theme, with Apple rising by 49% to become the first company in history to surpass a market capitalization of $3 trillion, Amazon up by 55%, Meta up by 138%, Nvidia up by 189% (a tripling), Microsoft up by 42%, Alphabet up by 35%, and Tesla up by 112%, the overall performance of Nasdaq stocks did not particularly shine. Overall, the Nasdaq is still down more than 15% compared to its peak in the fourth quarter of 2021.

- The outperformance of luxury:

Just as the tech sector drove the US market, the luxury sector boosted certain European markets such as France, thanks to the performances of LVMH (+26%), now the largest European company by market capitalization, L'Oréal (+27%), and Hermès (+36%).

As it is positioned neither in the former nor in the latter sector, the UK's FTSE limited its gain to 1% in the first six months. The Swiss market also had a limited evolution with a 5.4% increase.

Can we talk about bubbles in these two themes? The comparison with the technology bubble of the late 1990s is tempting, but there are notable differences, whether it be the financial solidity of these companies or the rapid growth of their revenues on a comparable basis.

- The underperformance of small and mid-cap stocks:

Since the beginning of the year, the global performance of these stocks has been flat as some investors, in a period of cyclical downturn, are staying away. However, these markets have numerous companies with steady and strong growth accompanied by good cash flow generation. Therefore, the coming months could become favourable for buying these stocks.

- The underperformance of "value" and financial stocks:

In 2022, for the first time in years, "value" stocks stood out. While growth stocks declined by nearly 30%, "value" stocks only experienced an 8.7% decrease, helping to cushion the global stock market decline of 19.4%. Since the beginning of the year, due to fears of a recession, whether justified or unjustified, these stocks have stagnated but remain often attractive.

Banking stocks, favoured by changes in interest rates, started the year very well. However, since the issues with Credit Suisse and the few regional bank failures in the United States, they have corrected and ultimately underperformed by the end of the first half, despite their overall strength (especially for European banks).

Conclusion: potential and prospects.

"We live in a changing reality to which we try to adapt ourselves like seaweed bending under the pressure of water," Lampedusa in ***The Leopard.***

In this changing environment, wonderfully captured by Lampedusa in The Leopard, what are the macroeconomic prospects? We can distinguish three divergent scenarios: some fear the consequences of too many interest rate hikes, namely a credit crunch and a recession; others anticipate continued inflation before a stagflation scenario; and still others, including our perception, anticipate a slow return to normal inflation in the next two years and, in the meantime, slow economic growth.

- ***From an economic perspective:***

AI, often feared, should facilitate a recovery in productivity gains, which have been weak at around 1% per year in developed countries over the past decade. Among the beneficiaries are functions such as marketing, customer service, research, and software. From Ford to Moderna to JP Morgan, numerous firms are utilizing AI to boost their productivity. Similarly, public and private spending in favour of energy transition benefits many industrial companies that are suppliers of components.

- ***From a monetary perspective:***

We still believe in a significant decline in overall inflation worldwide and a slow decrease in "core" inflation.

- ***From the perspective of stock markets:***

The gains in markets in the first half has done little to offset the losses of 2022, as the rally is highly concentrated in a handful of stocks.

While valuation ratios (price-to-earnings) for growth stocks in the United States are above their average of the past decade, this is not the case for other markets. China is significantly undervalued, but some investors are cautious due to political tensions.

The outperformance of European stocks, evident in 2022 (-11.8% compared to -20.7% for the US market, -23.5% for the Chinese market, -18.5% for the Swiss market, -19% for Asia excluding China), has continued in the first half, primarily against China (+16.4% compared to 0.5%), with the UK showing a modest increase of 1% and Switzerland with only a 5.4% increase.

- ***From a bond perspective:***

The expectation of an end to interest rate hikes in the fourth quarter, followed by a decrease in rates in the first half of 2024, should lead to a recovery in bond performance, particularly in some large emerging countries like Brazil.

- ***From the perspective of oil:***

Improved discipline within OPEC+ should support an increase in oil prices as unused production capacities are moderate.

- ***From the perspective of metals:***

Losses could be offset for copper, iron ore, and steel if China adopts stimulus measures, and losses could be mitigated for lithium, cobalt, and palladium, all beneficiaries of the energy transition.

The performance of gold remains lacklustre, resilient in 2022 and modest in 2023, but at least over an 18-month period, it is positive, which is rare in the investment universe.

- ***From a currency perspective:***

The depreciation of the $ is expected to continue against the €, as prospects for interest rate hikes are weaker, and the Swiss Franc is expected to remain strong.

Geneva, 6th July 2023

Bruno Desgardins
CIO
Switzerland

SingAlliance Pte Ltd
20 McCallum Street
#18-01 Tokio Marine Centre
Singapore 069046
T: +65 6303 5050
E: info@singalliance.com

SingAlliance (Switzerland) SA
16bis rue de Lausanne
1201 Geneve
Switzerland
T: +41 22 518 85 85
E: info.switzerland@singalliance.com

SingAlliance (Hong Kong) Ltd
Unit 904-907, 9/F Dah Sing Financial Centre
248 Queen's Road East
Wanchai, Hong Kong
T: +852 2639 3659
E: info.hongkong@singalliance.com

SingAlliance Pte Ltd
(DIFC Representative Office)
The Gate, Level 13 East, Office 10, DIFC
PO Box 121208 Dubai, UAE
T: +971 (0) 4 401 9158
E: info.dubai@singalliance.com

This document does not constitute an offer or a solicitation to purchase or subscribe financial instruments. Information contained in this document has been obtained from carefully selected public sources. Although every care has been taken to ensure that this information is accurate at the time of publication, no representation is made as to its accuracy, completeness, or truthfulness. Any opinion contained herein is subject to change at any time without notice. Past performance is not indicative of future results.