BELVOIR
CAPITAL AG

December 2022

Strategy Update

Introduction by Steffen Bauke, CEO

Dear investors,

2022 is bound to be remembered for a very long time – both in terms of geopolitics and investment. Bonds and shares have significantly lost value. Above all, the huge interest rates hikes, the stubbornly high inflation – unprecedented in recent decades – combined with war in Europe, has made this the worst year for stock markets in a long time. Stocks have fallen the most since the 2008 financial crisis, and bonds had their worst year in 96 years. This 4th quarter did not bring any relief to capital markets either, since higher interest rates are now expected in Europe following clear comments made by the ECB in December. We expect 2023 to be a challenging year, but one in which there may be opportunities for long-term investors. With interest rates now significantly higher, for the first time in a while, bonds offer a viable alternative to stocks. As to the stocks themselves, 2023 will offer a different view of these: value stocks will initially outperform growth stocks, and “stock picking”, as well as clever industry weighting, will be crucial this year. However, our outlook for 2023 is not as negative as that of the general investment community. Difficult times on the stock markets also mean that first-class stocks from companies with good cash flow and market dominance can be acquired at very attractive prices.

Zürich, 31st December 2022

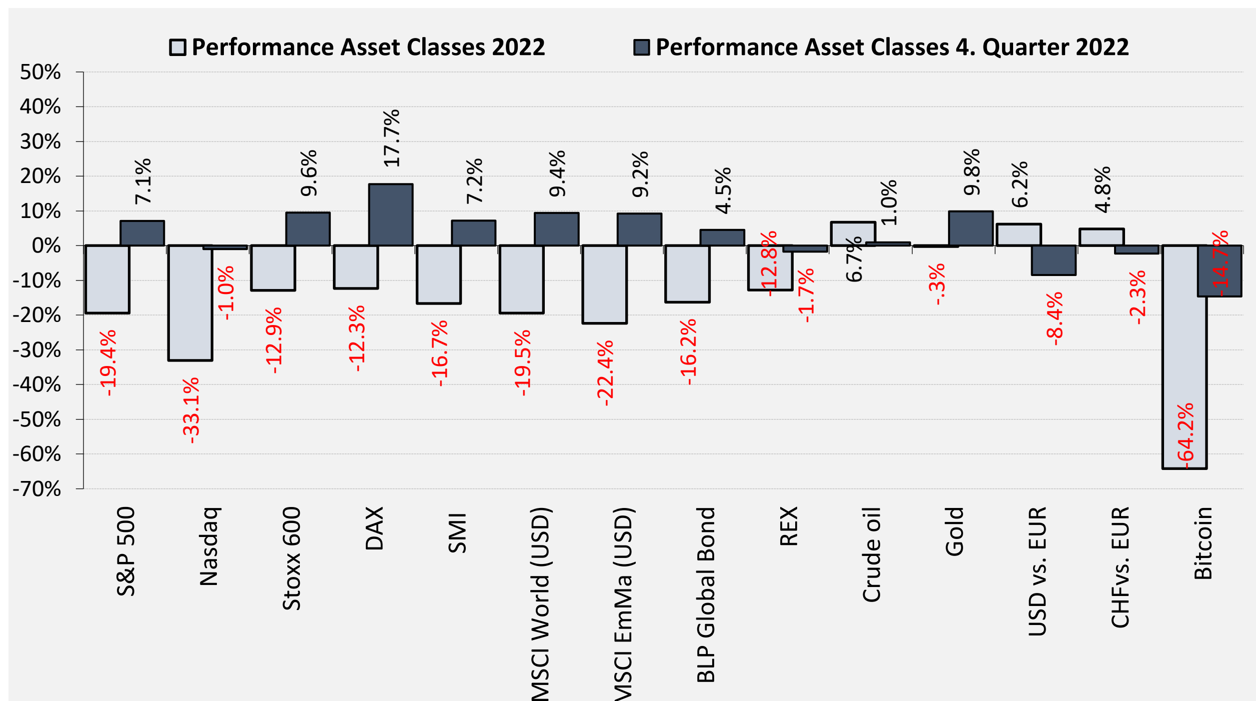
Strategy Update 4th Quarter 2022

31st December 2022

Review

2022 has not only been a challenge for investors. War in Ukraine, which just a year ago would have been unimaginable, inflation at a level not seen in about 30 years (mainly due to soaring energy costs), and the central banks tightening interest rates at a pace unprecedented in decades. Weakening economies in Europe and the US have wreaked dire consequences on the markets. For the first time in decades, stocks and bonds have fallen in the same year – and hugely so. Throughout 2022, the sharp rise in interest rates led to significantly higher discount rates, which in turn caused a plummet in stock markets. Cyclical and growth-oriented sectors suffered the most from this. The big US tech stocks, such as Amazon, Alphabet, Apple and Microsoft, experienced losses of 30-50%.

Development of selected markets in local currency



Source: Bloomberg

Long-term comparison – The development of US bonds and stock markets

Source: Financial Times (Robert J Shiller, TS Lombard, FT Calculations)

Defensive sectors and net asset values fared slightly better, while the healthcare and energy sector significantly outperformed the market. Surprisingly, the more "defensive" Swiss SMI lost more value (-16.7%) than the DAX (-12.3%). There was no year-end rally. The rate hikes by the central banks were in line with expectations. However, the exceedingly negative forecasts of certain central banks have triggered renewed uncertainty on the markets towards the year's end. With the collapse of the FTX stock exchange, cryptocurrencies suffered a massive loss in confidence. In the 4th quarter, the USD has weakened significantly once more, turning from its high of 0.98 to 1.07 (EUR-USD), contrary to most forecasts.

Outlook – A weak recession as the best-case scenario

Throughout the 4th quarter, economic prospects continued to deteriorate. Key indicators all point to a downward trend, with no signs of improvement until Q3 2023 at the earliest. The IMF now projects a global economic growth of 2.7% for 2023, down from its projection of 2.9% in October – in our view, this is still far too optimistic. The Eurozone and the UK will slide into recession, bottoming out in mid-2023. Within the Eurozone, pressure on the energy sector is likely to ease

at the beginning of March. Extensive fiscal packages and the remaining high backlog of orders for companies should ensure that the coming recession should be mild. Labor markets are also remaining robust. However, if interest rates remain high for much longer, there is a risk that the recession could worsen, as this would affect real estate markets. Long-term mortgage interest rates have already doubled in the US, leaping from 3% to over 7%. This has had a corresponding impact on real estate markets. In addition, wage growth is unlikely to keep pace with inflation, which in turn limits consumption.

Inflation – Still a theme throughout 2023

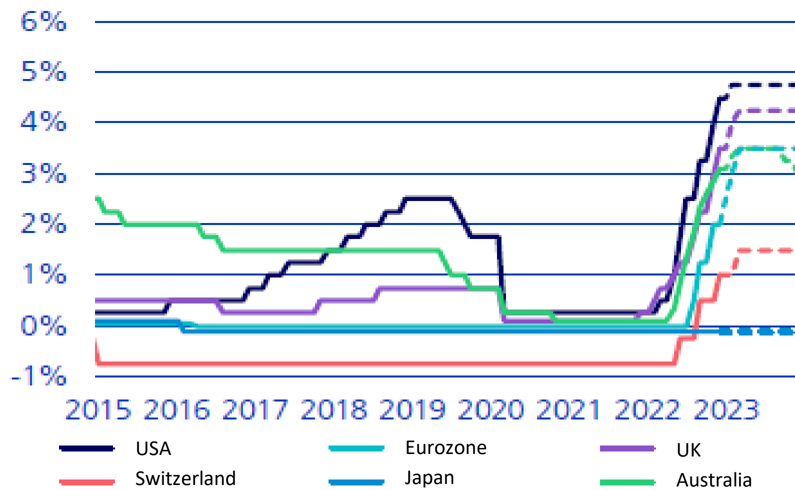
It is wishful thinking on the part of politicians and central banks that inflation will soon return to 2%. All signs point to higher inflation in the medium term, fueled by de-globalization, labor shortages in many economies, lack of investment, and the risk of a wage-price spiral. Throughout 2022, the main inflation drivers were higher energy and commodity prices. In 2023, it will be the factors of labor and higher wages that will prevent a significant drop of inflation. The labor market is particularly robust in the US. Since a transition to climate-neutral energy sources requires higher spending on armaments and vast amounts of raw materials, prices for these raw materials are likely to remain high or even rise. For 2023, the ECB expects inflation of 6.3%. It will be far beyond next year before we see a return to the targeted 2%. Price increases are slowing down, but at a snail's pace.

Central banks – No interest rate cuts before 2024

Anyone who still believed at the end of 2022 that central banks would take a less restrictive path on tightening monetary policies will have been disappointed in recent weeks. Although the pace of rate hikes has slowed, markets have been caught out at the prospect of much higher and – crucially – longer interest rates. Central banks are catching up on what they failed to do a year ago: ECB President Christine Lagarde made more forthright comments than expected in December, announcing that several more interest rate hikes are to come. In 2022, the US Federal Reserve raised interest rates seven times, the rate rising by 0.75% four times in a row – an unprecedented move. As usual, central banks reacted too late. The target range is now 4.25-4.5%, while this was still 0-0.25% at the beginning of 2022. Indeed, Jerome Powell hinted that the job wasn't done yet: In the first half of 2023, central banks will continue to raise interest rates, albeit in smaller increments. The US Federal Reserve is expected to hike interest rates to 5-5.5%, and the ECB to 3-3.5%. The SNB could raise the key interest rate to app. 1.50%. We can assume that the

rate hike cycle will come to an end by the summer. We currently do not expect any interest rate cuts before 2024.

Development of and expectations for key interest rates



Source: Swisscanto

Bonds – A suitable alternative once more

In 2022, bonds had their weakest year in 96 years. For the first time ever, the US bond market recorded losses for two years in a row. Now, bonds offer a great potential for diversification once more, if they are a part of a balanced portfolio. We do not foresee a dramatic rise in interest rates again in 2023; in fact, they are expected to fall given the expected recession, meaning a short-term potential for price gains. This assumption is already reflected in the inverse yield curve (short maturities that offer higher yields than long maturities). USD bonds are the most attractive, although investors should not underestimate the currency risk. Depending on the credit rating and the terms, you can now buy returns to gain 5-7% p.a. Currently, bonds do not offer real yield, but this may change if inflation comes down due to the base rate effect on prices. Here, we can focus on actively managed and hybrid funds that generate added value, as well as individually selected bonds with good credit ratings.

Stock markets – No significant rebound expected

Often, a bad stock market year like 2022 is followed by significant recovery in the next – yet, we can't assume that. Inflation remains at a high level – particularly in Europe – which leads to declining economic development. This is coupled with a hardening of fronts in the Ukraine war, alongside China experiencing a difficult phase. This combination of high interest rates and economic slowdown is like a carpet suffocating stock exchanges. In addition, earnings expectations for most stocks are still far too optimistic. It is only once earnings forecasts or their prospects brighten, and interest rates stop rising, that stock markets will experience sustained recovery. Until then, tech stocks and highly valued stocks will have a hard time in particular. For now, uncertainty and volatility are bedded in. In the past, expected recessions for Europe and the US have always been associated with declining profits and stock market corrections. Stock markets have already been pummeled, but some underestimate the negative impacts a recession can have on corporate profits. This is why it's important to focus on individual sectors, and on companies within them that have high pricing power (ones with high profit margins or which can maintain them) and which are less dependent on the economy. Moreover, given rising interest rates, the degree of company debt has to be considered. Stocks with high dividends are the better option.

Throughout 2023, the stock year is likely to remain volatile and unsteady, moving horizontally. For investors, it will be key to focus on how well central banks bring inflation under control, and how long and how deep the expected downturn will be. It's impossible to time the market exactly. We remain invested in quality.

With a price-to-earnings ratio of 15.3 (expected profits over the next 12 months), the MSCI World Index is roughly trading on the 20-year average, with the US being relatively expensive with a P/E of 16.8, and Switzerland at 16.5. Europe is relatively cheap, with a P/E of 12.0. Europe's dividend yields are also comparatively high, at 3.5%. Despite growth stocks experiencing high losses in 2022, the MSCI World Growth Index is still trading well above the 20-year average of 18, with a P/E ratio of 21. On the other hand, its counterpart, the Value Index, has been trading below its average of recent years.

Defensive sectors usually remain relatively protected from economic downturns, while value stocks tend to perform well when inflation is high. As investors begin to anticipate a bottoming out of economic activity and a fall in interest rates later in the year, this is a point at which great opportunities may arise for buying cyclical and growth stocks.

Currencies – Overvaluation of the USD

As long as the US Federal Reserve's perspective remains conservative, the USD should benefit from support. A stronger than expected recession would also have a positive impact on the USD. In addition, the interest rate hikes announced by the ECB have given the euro renewed impetus. However, once the Fed policy changes, investors should brace themselves for a weaker dollar. The USD is currently overvalued by about 30%, in terms of purchasing power parity.

Over the coming months, the CHF is likely to appreciate against the EUR and USD. This is due to the recession in the Eurozone, the impact of the Russia-Ukraine war, worries about the sustainability of European sovereign debt, Switzerland's high trade surplus, and the willingness of the SNB to allow a CHF appreciation. As in the last year, inflation is likely to be significantly higher in Europe than Switzerland in 2023 (an estimated 6.5% vs. 2.5%), which will also support the CHF.

Gold – Decreasing negative factors in 2022

Since Europe is amidst the biggest geopolitical conflict since the Second World War, leading to uncertain outcomes and a risk of further escalation, one would expect gold to rise in value as a crisis investment – but this is not the case. In 2022, gold gained just 2.3% in value (in USD per oz). These gold prices were weighed down by higher interest rates and a strong USD. However, given that bond yields are likely to peak soon, the central banks' cycle of rate hikes possibly ending by the summer, and the USD weakening in the medium term, gold should no longer be negatively impacted. We have also noted significant decreases in outflows from gold ETFs. Gold still has a place in our portfolios, as it is a good crisis hedge investment and offers protection against inflation.

Gold development; last 3 years, USD per oz

Source: UBS Quotes

Conclusion – Forecast

To be honest, the shock of 2022 is still palpable in our bones. However, it's crucial to stick to a long-term investment strategy. Equities are still the best long-term asset class and offer suitable protection against inflation. Of course, we're aware that timing can be difficult to impossible. The challenges of 2022 will not be so quick to disappear: inflation will follow us into the new year, there is no end in sight to the war in Ukraine, and we have not yet seen the full depths of the economic slowdown. Regarding the interest rate hikes by the central banks; we predict these to end by the summer, with bond yields hardly rising. As to bonds, we can almost certainly expect to be spared the losses of 2022. In fact, most companies are doing well, and will continue to generate cash flows in the future, with total dividends at record highs. It is said that the Chinese word for 'crisis' is based on both risk and opportunity. We also expect greater opportunities in the stock sector once more and will be taking advantage of them on your behalf. A sole strategy of "buy and hold" is simply not enough. Instead, it will be necessary to apply good stock picking and intelligent industry weighting skills, as well as short-term adjustments in tactical allocation.

Thank you for placing your trust in us, and we are always available for further information and to answer any questions.

Your Belvoir Team

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