MAY 2022

MONTHLY INVESTMENT OUTLOOK

UBP

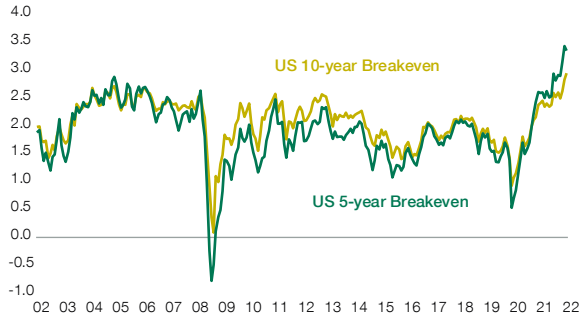
Union Bancaire Privée

MONTHLY INVESTMENT OUTLOOK

GROWING RISKS ON THE HORIZON

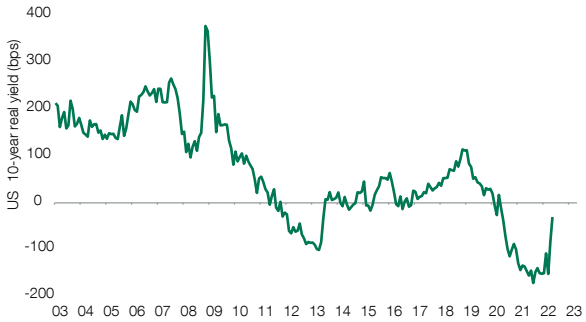
- April saw the coordinated bond and equity sell-off continue as the ECB joined the increasingly hawkish tone out of the Fed and added to heightening growth concerns in the month.
- Indeed, this shifting in the growth-inflation balance is highlighted by the IMF's recent forecasts with global growth now expected to reach only 3.6% while inflation is expected to hit 5.7% in 2022 following its second change in forecasts in 2022.
- Rising long-term inflation expectations increasingly appear to be a concern for the US Fed as a series of 50 bps rate hikes is now on the table starting in the spring as the US central bank seeks to move more aggressively from its currently easy policy settings to outright tight as quickly as possible.
- With US 10-year yields having reached the upper end of our 2.5-3.0% target range in April, elevated long-term inflation expectations suggest that a move to 3.0- 3.5% is needed moving into the summer to reset inflation-adjusted interest rates across the yield curve back into positive territory and align with Fed hawkish policy settings.
- As a result, we have increased fixed income hedge fund allocations to shield investors further from not only the expected additional rise in long-term yields but also, we anticipate, a pick up in credit spread volatility as the prospect of a slowdown in economic growth is better priced in moving into 2H2022.
- Earnings remain a tailwind for US and European equities moving through the current reporting season in progress. However, should risks to economic growth continue to build in the spring and through the summer months, 2H2022 and 2023 earnings expectations may face growing headwinds.
- Moreover, as we exit earnings season and the next stage in the Fed tightening cycle takes hold starting in mid-May, an upcoming leg to the rising yield backdrop that has plagued the asset class so far in 2022 may once again move to the forefront of investor attention.
- On the FX front, though US dollar strength year-to-date has been unrelenting, we expect it will require signs that non-US, global central banks will take up the mantle of tightening at a faster pace than expected in the US to reverse the current trend. Without this, further US dollar strength and global instability that usually accompanies it may emerge moving into the summer.

Rising long-term inflation expectations suggest inflation is becoming unanchored....



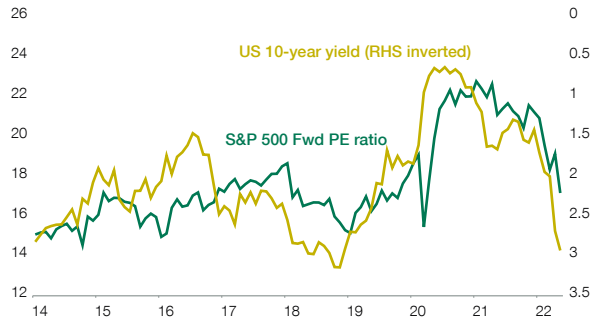
Sources: Bloomberg Finance L.P. and UBP

... warranting a tigher policy via positive real interest rates across the yield curve



Sources: Bloomberg Finance L.P. and UBP

US equity valuations underprice the rise in long-term yields



Sources: Standard & Poor's; Bloomberg Finance L.P. and UBP

GLOBAL TACTICAL ASSET ALLOCATION

STAY SHELTERED IN ALTERNATIVE STRATEGIES

Global economy / Asset allocation

- Global activity was quite resilient in Q1-22, but downside risks accumulate in Q2 as the Russia-Ukraine conflict continues and visibility remains low.
- Europe looks the most exposed to recession risks in the short run, while upside risks remain in place on inflation.
- Major central banks, except Japan and China, have adopted a more hawkish communication and have prepared markets to a more aggressive tightening in the coming months.
- In this context, risks are mounting in both fixed income and equity space. Investors could find some sources of shelter in alternative strategies such as credit arbitrage, CTA or global macro for fixed income alternatives and equity long-short strategies for equity allocation.
- Risk management is again the key looking ahead. Put options should protect investors from any sharp sell-off in equity markets and growing recession risk on the horizon.

Fixed income

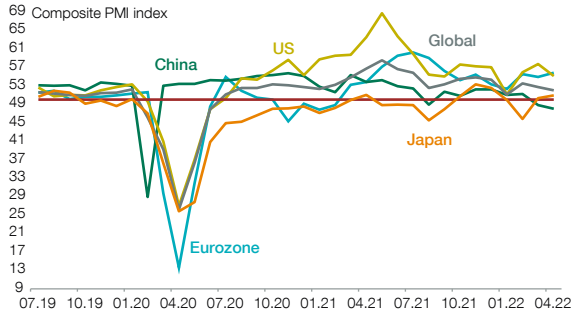
- Bond market sell-off continued during the month, pricing in more aggressive monetary policy and inflation risks. US 10y bond yields could reach 3%-3.5% after the previous rise from 2% to 3% over past months.
- Bond yields turned more volatile on renewed fears of recession fuelled by extended China lockdown and more aggressive Fed tightening.
- Short duration investment grade corporate bonds and hedge funds strategies are preferred within the fixed income allocation.

Equities/ Alternatives

- Valuation risks remain and earnings underprice rising recession risks. High PE multiples are susceptible to PE compression as yields complete their normalisation. High quality earnings and dividend streams can provide relative shelter.
- Hedge funds are particularly valuable in generating alpha in markets with rising volatility. We further rotated some of our directional holdings both in equity and in fixed income into the asset class.

Activity is expected to slow down in Q2

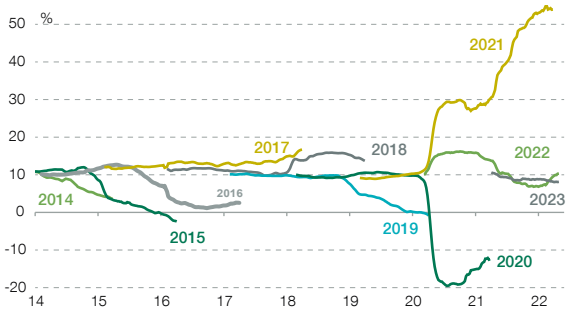
Business confidence



Source: S&P Global

Earnings expectations look optimistic given substantial risks on activity

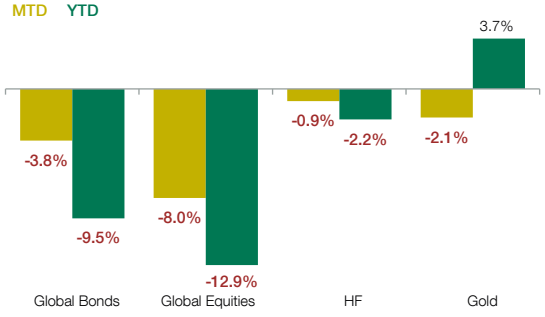
Consensus EPS growth expectations for global equities



Source: Refinitiv

Sell-off across all assets including gold

Major Assset Classes Performance



Performance is as end of April 2022
Sources: Refinitiv, UBP

UBP ECONOMIC OUTLOOK

MAJOR DOWNSIDE RISK ON ACTIVITY NEXT QUARTERS

Lower visibility and building downside risks

- A significant slowdown is expected in global activity after still quite resilient Q1, due to end of pandemic restrictions in several countries.
- The combination of higher inflation, enduring Russia-Ukraine conflict, extended lockdowns in China and tighter global monetary policy should lead to weakening global supply and demand in the next quarters.
- Continental Europe appears the most exposed to recession risks due to geopolitical uncertainties in the short run and fears of major energy shortages; the Chinese growth story could be severely hit in Q2 by the "Covid-O" policy and the costs of the related lockdown in several major Chinese cities.
- US activity is challenged in the medium term by the Fed's willingness to engineer a significant slowing. External shocks combined with more aggressively tight monetary policy may potentially push the post pandemic high growth cycle into jeopardy in 2023.

Inflation: remaining upside risks in Q2

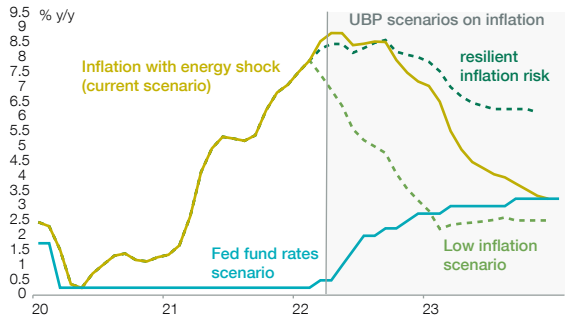
- Inflation registered the impact of soaring energy prices, higher costs due to renewed disruption in trade and industry and rising momentum in service costs; inflation should remain high in Q2, and some demand destruction could be seen because of deteriorating purchasing power.
- With a tight labour market, continued wage growth is expected in the US and could come later in 2022-2023 in the eurozone. No major easing in inflation is expected before Q3-22, and any significant decline is postponed to mid-2023.

The ECB poised for an early lift-off in key rates

- The ECB has opened the door to an early interest rate adjustment beginning in July, after mentioning the option to move in September and December to accelerate the fight against inflation despite mounting downside risks on activity. ECB's liquidity injections should end by this June.
- Viewing the US labour market as running "too hot", the Fed looks set to hike key rates more aggressively in the next meetings, raising key rates close to 2.75%-3% by Q4-22/ Q1-23. The Fed is also expected to reduce its balance sheet in May with maturing Treasuries and mortgage bonds purchased during the pandemic.

High inflation in place in the US

US inflation



Sources: BLS, Refinitiv, UBP

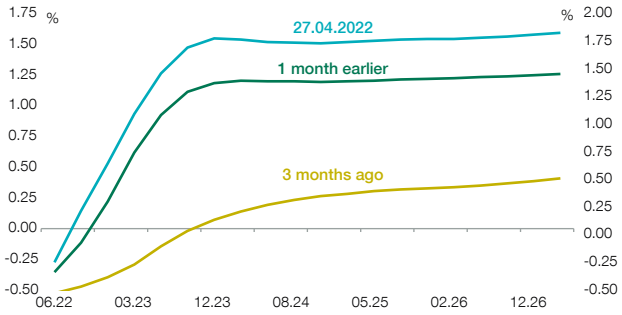
Moderate growth expected in 2022

GDP y/y %	2020	2021	2022
WORLD - *MER*	-3.5	5.6	3.0
*- on PPP basis**	*-2.9*	*5.8*	*3.3*
USA	-3.4	5.7	3.0
Japan	-4.5	1.8	2.5
Eurozone	-6.4	5.3	2.0
United Kingdom	-9.3	7.2	3.8
Switzerland	-2.5	3.8	2.5
Brazil	-3.9	4.8	0.5
Russia	-2.7	4.7	-12.0
India	-8.2	8.5	7.0
China	2.2	8.1	5.0
Developed countries	-4.8	5.1	2.7
Emerging countries	-1.7	6.3	3.6

Source: UBP - Economic & Thematic Research
MER: market exchange rates; PPP: purchasing power parity

Aggressive ECB rate adjustment priced in money markets

Eurozone: expected ECB rate path using eurolibor futures



Sources: Bloomberg Finance L.P., UBP

UBP ECONOMIC OUTLOOK

CHINA: HEADWINDS MOUNT AMID EXTENDED LOCKDOWN AND LIMITED MONETARY SUPPORT

Extended lockdowns weigh on Q2 activity

- Shanghai has remained under lockdown since early April, but other cities have been impacted as well. The areas currently undergoing full or partial lockdowns account for almost 20% of China's GDP. Together with rising inflation, this will dampen Q2 economic activity.
- The main channel will be domestic consumption. Retail sales contracted -3.5% y/y in March for the first time since 2020. We expect to see an even sharper decline in April and May. Manufacturing activity will also be affected by labour shortages and disruptions to operations. Industrial production remained supported at 5.0% y/y in March but will cool over coming months. April's PMI figures declined to 47.4, the weakest reading since February 2020.

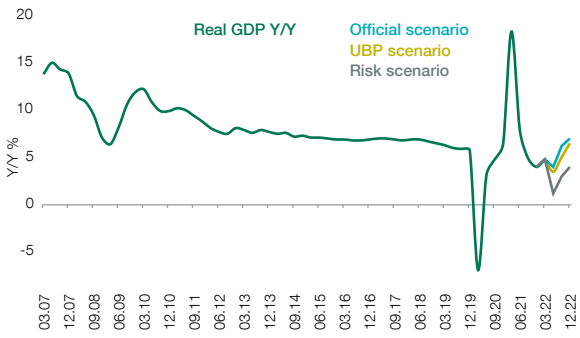
PBOC has delayed its support post lockdown

- Although the central government has ramped up its rhetoric in the past few months, the People's Bank of China (PBOC) has not yet delivered resolute policy support. On April 20, the PBOC opted to keep its Loan Prime Rate (LPR) unchanged at 3.70% for a third consecutive month. This followed a modest 25 basis point (bp) cut to the Reserve Requirement Ratio (RRR).
- There are several factors that may be holding back the PBOC. Firstly, rising long-end US yields have eroded China's rate differential with the US, resulting in capital outflows. Moreover, trimming interest rates while lockdowns remain in place will do little to boost real activity. Lastly, stronger than expected GDP growth in Q1 (4.8% y/y) buys them time to evaluate policy options.
- The PBOC pledged to use an "arsenal" of tools in 2022. State banks have cut mortgage rates by 20-60 bp across more than 100 cities. Together with April's modest RRR cut, these measures nudged interbank rates lower. Going forward, we think that the PBOC will deploy monetary aggregates more aggressively. Moreover, we cannot exclude the possibility of a 10 bp cut in June and an additional 25-75 bp in RRR cuts.

GDP target of 5.5% will be hard to achieve

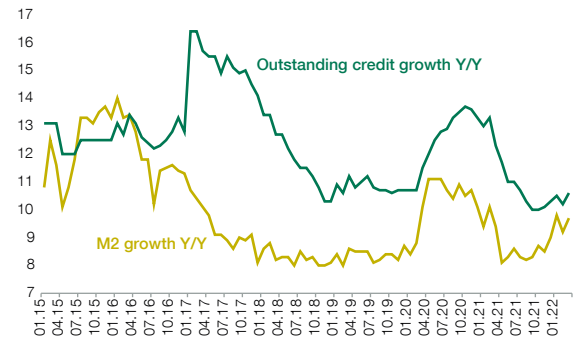
- The weakest "quarter" of growth has shifted from January-March to March-May. We have therefore downgraded our growth projections for Q2 3.5% y/y (consensus: 4.6%). Under our baseline scenario, the government will miss its growth target in 2022, but 5.0% could still be achieved in case we see a stabilisation around 5.5% y/y in H2, led by pent-up demand.

China GDP scenario



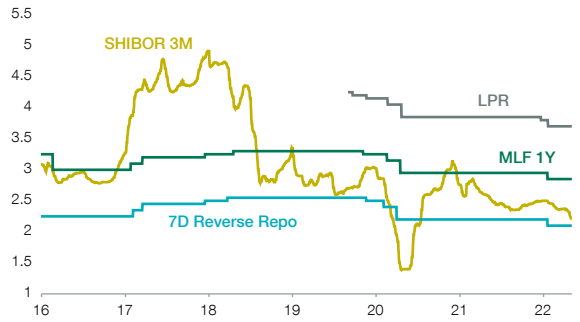
Sources: NBS, Bloomberg Finance L.P., UBP

China M2 and credit growth



Sources: PBOC, Bloomberg Finance L.P., UBP

China interest rate corridor



Sources: PBOC, Bloomberg Finance L.P., UBP

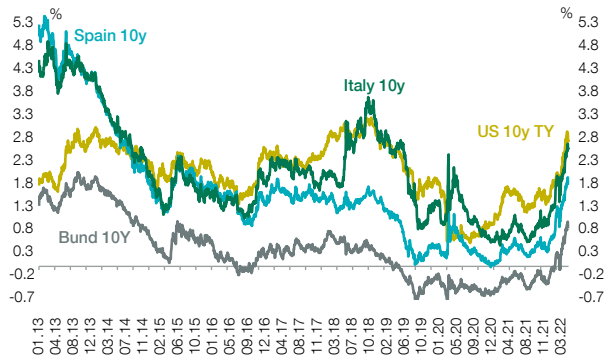
GLOBAL BONDS

PREFERENCE FOR ALTERNATIVE STRATEGIES

- The sell-off in bonds continued fuelled by more hawkish rhetoric from central banks, a strong US labour market, and remaining upside risks on inflation. Bond markets are now expecting a tighter Fed policy, with several 50 bp adjustments in rates at the next FOMC meetings; the decrease of its balance sheet, ending reinvestment in Treasuries (USD 60 bn) and in MBS (USD 35 bn), could also add pressure.
- A more hawkish ECB's communication prompted expectations of an early lift-off in rates and the ECB will be obliged to revise up its inflation scenario. In addition, the ECB's asset purchases (APP) and liquidity injections via most accommodative TLTROs conditions should end in June, putting additional pressure on market liquidity.
- Upside pressures remained on long bond yields. After the increase from 2% to close to 3% over past months, US 10y yields could evolve in a 3%-3.5% range in the next quarters underpinned by aggressive Fed tightening, unanchored inflation expectations and renewed pressures from Treasury refinancing at a time the Fed reduces its purchases.
- European yields also face upside pressures given the agenda on key rates suggested by the ECB's communications. German inflation expectations have reached new highs, suggesting pressure on ECB to act sooner than later, while European budget policy should support economic activity as it contends with the energy shock and the impact of the Russia-Ukraine conflict.
- Higher volatility on bond yields has been fuelled recently by extended lockdowns in China, risks of energy shortage in Europe, Fed policy, and a few disappointments in earnings. Renewed recession risks have driven a temporary pause mid-month on the rising yields trajectory. In such an environment, bond allocation remains underweight on government bonds with still short duration positioning.
- Credit spreads have narrowed in the US, after initial widening at the beginning of the conflict, underpinned by still improving ratings in the Investment grade segment, which remains our preferred position. But more volatility is expected in global credit spreads with concerns on growth and inflation and a cautious strategy remains in place with focus on credit quality. Preference still exists for hedge funds strategies within the fixed income allocation.

US and European government bond yields on sharp rise

Government bond yields



Sources: Bloomberg Finance L.P., UBP

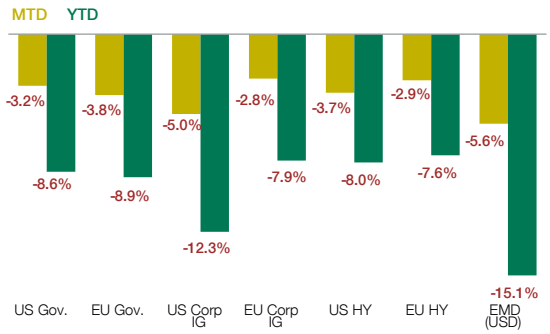
US inflation expectations have increased further, driving real yields based on TIPS higher

US inflation expectations and real yield (based on 10-year TIPS)

Sources: Bloomberg Finance L.P., UBP

Nowhere to hide across all fixed income segments

Fixed income performance



Performance is as end of April 2022
Sources: Refinitiv, UBP

GLOBAL EQUITIES

VALUATION AND EARNINGS RISKS WARRANT A CAUTIOUS STANCE

- With concerns over global growth continuing to gather pace and growing fears that central banks will be unable to achieve a soft landing, equity markets remained under pressure over the last few weeks.
- Most companies once again announced Q1 earnings above consensus expectations. Lots of them sounded more cautious than at the start of the year given the rise in uncertainties, notably related to the lockdowns in China and the potential impacts of the war in Ukraine.
- As a result, fewer companies in Europe have upgraded their guidance than before, but the percentage of companies being negative on guidance remains low and most of them kept it unchanged.
- Energy cost inflation has become a concern for a larger subset of firms, but other issues related to higher labour and raw material costs appeared broadly stable versus the previous quarter. Overall, most companies were optimistic about maintaining high level of margins.
- Following the first half of the reporting season, EPS growth estimates remained roughly unchanged. In the US, earnings growth estimates for the current quarter (Q2) have stayed flat at around 6-7% (vs 5% at the start of the year), and at 9% and 10% respectively for 2022 and 2023.
- In Europe, the forecast growth rate for Q2 even rose 5pp to 14% over the past month thanks to the commodity-related sectors. The consensus expects earnings to grow by 11% this year.
- Given the elevated risk of a sharp downturn in economic activity following the conflict and the sharp rise in energy costs, particularly in Europe, current earnings estimates could well be revised downwards in the coming months.
- We are therefore cautious on equities, especially as current valuations do not price in a potential recessionary scenario in Europe. In the US, a further increase in bond yields is also likely to weigh on valuation multiples.
- In this context, we want to focus on companies with strong balance sheets, which offer high visibility on earnings and solid dividend yields.
- Moreover, we retain our asymmetric strategies that we had implemented via options and structured products in portfolios.

Better-than-expected Q1 earnings, but no upward revisions for Q2

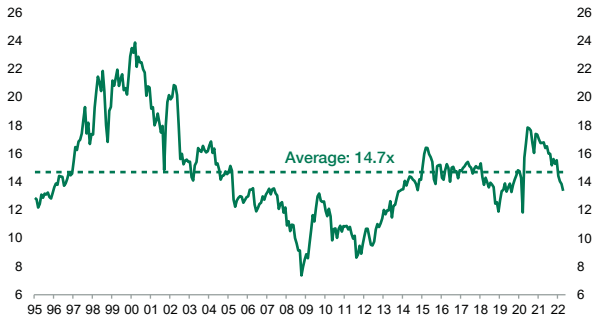
S&P 500 - consensus EPS growth (y/y, %)

Sectors	Q4 21	Q1 22	Q2 22	Q3 22	2022	2023
Consumer discretionary	53	-8	15	42	17	24
Consumer staples	7	7	0	3	4	9
Energy	11303	254	163	65	86	-10
Financials	9	-19	-18	-4	-10	14
Healthcare	27	14	6	5	7	0
Industrials	42	38	31	33	37	19
Materials	65	43	17	11	16	-5
Real estate	20	24	2	11	11	7
Technology	24	13	4	8	9	13
Communication services	19	-4	-11	-1	-4	16
Utilities	1	9	-12	-8	2	8
S&P 500	**32**	**10**	**6**	**11**	**9**	**10**

Sources: Refinitiv, UBP

European equities are still far from pricing in recession risks

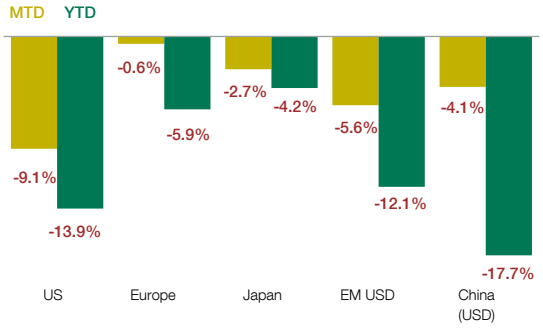
MSCI Europe: 12-month forward PER



Sources: Refinitiv, UBP

Sharp sell-off across all markets led by US markets

Equities' performance



Performance is as end of March 2022
Sources: Refinitiv, UBP

RECENT CHANGES

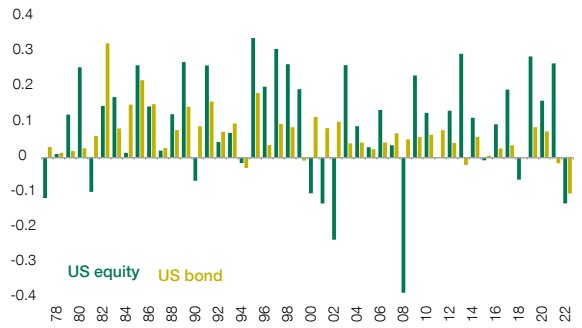
RISK MANAGEMENT IS PARAMOUNT IN MARKETS WITH LOW VISIBILITY

- Market conditions continued to deteriorate after the short-lived rebound in March. China's "Covid-0" policy added another layer of downside risk in addition to the prolonged Russia-Ukraine war. Inflation seems to stay higher for longer as supply chain bottlenecks as well as the energy and food shock worsen.
- Against this backdrop, central banks are increasingly aggressive at a time when the global economy is already slowing from the initial recovery phase after the pandemic. Markets are increasingly worried by a recession triggered by a policy error.
- In this context, the visibility is very low and uncertainties are growing. Risk management again becomes the key looking ahead. High inflation combined with lower growth poses downside risks to both fixed income and equity investment.
- As a result, we stay sheltered in alternative strategies such as credit arbitrage, CTA and global macro as fixed income alternatives and long-short strategy for equity alternatives.
- With increasing equity volatility and drawdowns, a proactive and dynamic risk management approach remains key. We are actively managing our tail risk protection through put options.
- In the fixed income space, we stay in short duration and capital protected structured products.
- In the equity space, we exited our high growth holdings that are more at risk in an environment of rising interest rates. We also exited our China exposure amid increasing uncertainties related to renewed Covid lockdowns. We stay focused on high-quality companies with high visibility in earnings despite recent underperformance.
- We keep some oil related exposure through a structured product offering 150% upside on WTI with partial protection on the downside. The exposure provides us with some hedging in case of a prolonged commodity shock.
- We also added USD across all portfolios as a hedge against recession risk. The US economy is the most resilient among developed markets and usually outperforms in cases of a sharp market sell-off.

Since 1977, we have never experienced both bonds and equities losing more than 10% since the start of the year

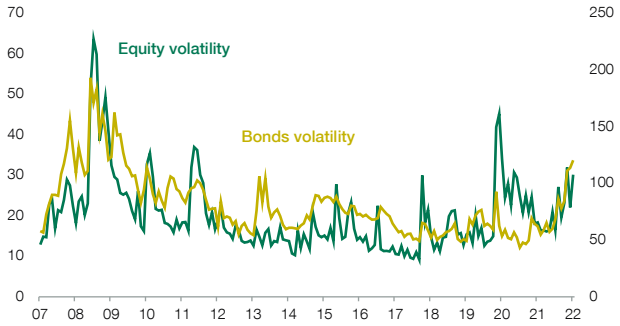
US equity and bond performance

1977- YTD 2022 (05/05/2022)



Sources: Refinitiv, UBP

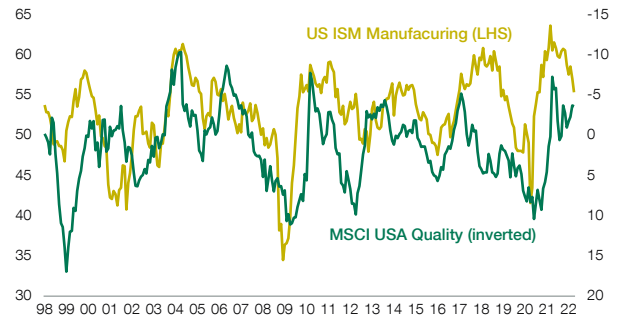
Elevated volatility both in equity and bonds markets



Sources: Refinitiv, UBP

Quality should prevail in a slowing economy

MSCI US Quality vs ISM



Sources: Refinitiv, UBP

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