AUGUST 2022

# MONTHLY INVESTMENT OUTLOOK

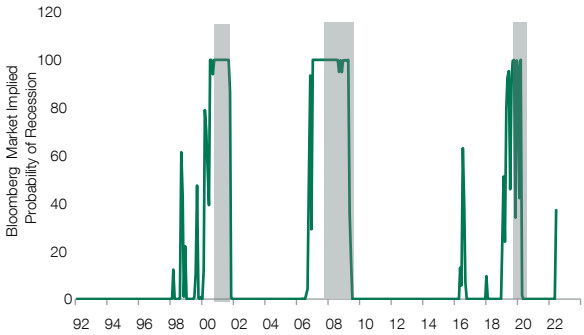
UBP

Union Bancaire Privée

# RECESSION RISK – THE POINT OF RECOGNITION APPROACHES

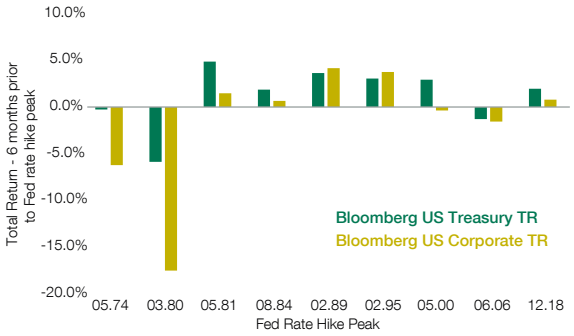
- Just as markets had to reprice a new interest rate regime in early-2022 amidst fading hopes for a transitory inflationary backdrop, they are now similarly beginning to recognise that the prospects of an economic soft landing are fading, and the risks of recession are on the rise.
- Indeed, market implied probabilities of recession – which rose going into the 2000, 2008-09, and 2020 recessions – are once again moving up, but still falling short of the economic shocks, but not outright recessions seen in 1998 and 2016.
- Despite rising recessionary risks, we do not expect either the US Federal Reserve or the European Central Bank to pause their respective rate hiking cycles, until at least September as both await signs of an easing in inflationary pressures. As noted last month, such a focus on a historically lagging indicator, may risk a deeper downturn in the labour market and/or manufacturing sector ahead.
- Markets, however, are anticipating that the Federal Reserve will pause its rate hiking cycle as futures markets forecast a 3.3% Fed Funds rate by year end (vs. 2.5% currently) to try to avert this risk.
- Even if correct, history suggests that Treasuries and credit offer the more attractive risk-return profiles ahead of and even after rate hikes end. Since 1981, US Treasuries and USD credit have delivered flat/positive returns in the six months prior to an end to Fed rate hikes. In the six months following an end to rate hikes, Treasuries and credit have delivered, averaging 7.9-8.4%.
- Equities have delivered a more mixed picture than bonds in the six months prior to an end to Fed rate hikes. Since 1989, equity investors have earned 5.8% average returns as the final Fed rate hikes were implemented. However, investors had to weather average drawdowns of -5% as well as a near 13% decline in December 2018.
- Moreover, during the high inflation periods of the 1970s and early-1980s, investors saw an average of -5% returns as Fed rate hikes came to an end with maximum drawdowns of -7.6%.
- As a result, in addition to our recent addition to USD duration at Treasury yields above 3% and a focus on high quality credit, we have pivoted our hedge fund allocation from long-short equities and credit arbitrage towards global macro strategies and CTAs. This shift will add an additional cushion to portfolios amidst the credit and equity volatility that typically comes at this stage of the economic cycle.

Risks of recession rising though still short of a 1998 or 2016-style, non-recessionary shock



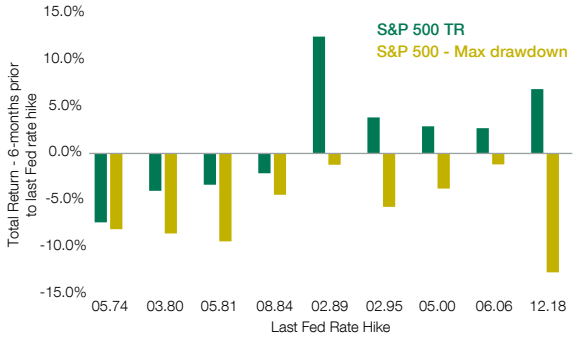

Sources: National Bureau of Economic Research, Bloomberg Finance L.P. and UBP
Note: NBER recessions in grey

Since 1981, Treasuries/Credit have seen flat/ positive returns as rate hikes near an end




Sources: Bloomberg Finance L.P. and UBP

Equities have delivered a mixed picture, with deeper drawdowns as rate hikes end




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

GLOBAL TACTICAL ASSET ALLOCATION

# FAVOUR QUALITY AND ASYMMETRY

## Global economy / Asset allocation

- Recession risks are increasing in developed countries; Europe is facing both an energy and a political crisis, in parallel with high inflation and rising key rates.
- Inflation remains high, fuelled by volatile energy and the rising cost of food and services. Markets fears are now centred on recession building on worries about high inflation.
- Central banks on track to hike further and aggressively. Inflation fighting remains the top priority in developed countries as central bankers act to minimise recession risks.
- As a result, despite the rally in July, we remain cautious on risky assets. We continue to favour quality both in fixed income and equity allocations. Companies with strong balance sheets and high earnings visibility should outperform going forward.
- We also maintain the asymmetry in portfolios through structured products, hedge funds as well as put options.

## Fixed income

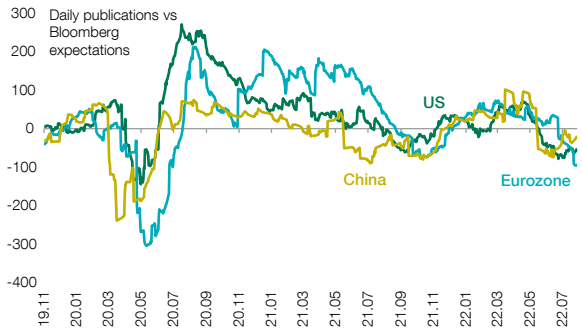
- Weakening economic indicators and rising political risks in Europe have fuelled recession fears as 10y government bond yields have eased in the US and Germany.
- Inflation has not yet peaked, and major central banks look set to hike key rates further over the coming months, fuelling volatility on short and long bond yields.
- Short duration investment grade corporate bonds and hedge fund strategies remain preferred within the fixed income allocation.

## Equities/ Alternatives

- Q2 earnings have not been as bad as feared by many investors but mixed guidance has finally prompted analysts to revise their estimates downward, particularly for 2023. We expect this trend to continue in the coming weeks. We therefore retain a cautious approach on equities and favour high visibility/high quality earnings streams
- Hedge funds are particularly valuable in generating alpha in markets with high volatility. We pivoted some allocation from long-short equities and credit arbitrage towards global macro strategies and CTAs to add an additional cushion to portfolios.

### Economic surprises have deteriorated, notably in the eurozone

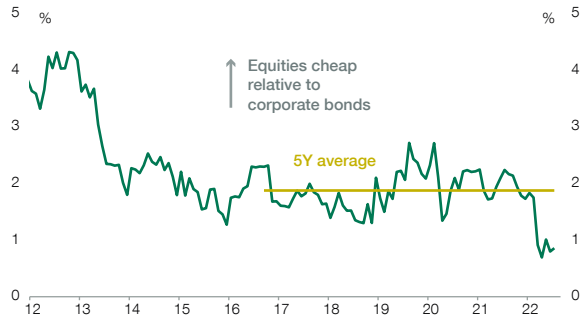
Surprise index - daily




Source: Citigroup Global Markets

### Equities have become less attractive relative to bonds, even before the looming earnings cuts

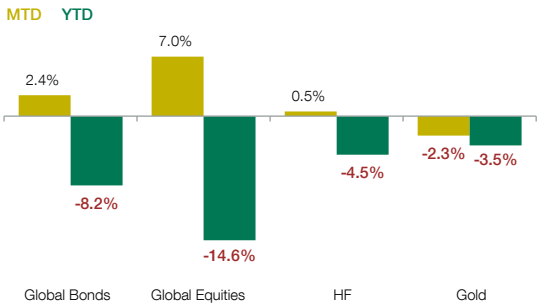
US: equity yield vs cost of debt
Spread between earnings yields (inverse of the P/E ratio) and corporate bond yields (BBB, 7-10y yield)




Source: Refinitiv

### Both bonds and equities rebounded in July

Major Asset Classes Performance




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

UBP ECONOMIC OUTLOOK

# ACCUMULATED RISKS WEIGH ON EUROPE

## Key points:

- Moderate growth is expected in 2023: activity in developed countries is set to contract while a more positive momentum should build in China.
- Tail risks weighing down on the growth outlook, with potential energy shortages in Europe, Covid cases in China and a deteriorating geopolitical environment.
- Inflation should progressively decline late in 2022 and 2023, but energy and food prices are volatile, and services are on a rising trend.
- Monetary policy has turned restrictive except in Japan and China. No reversal in policy is expected before inflation is seen to pass its peak.

## Europe is facing an energy and political crisis

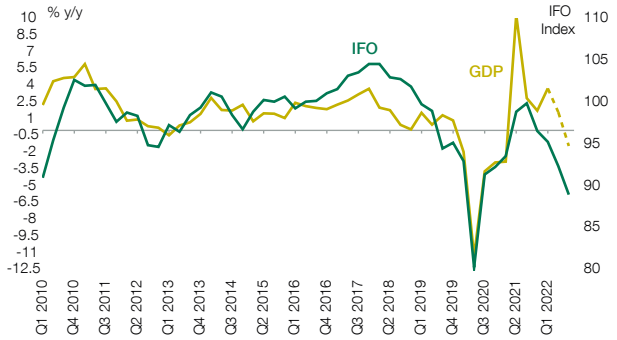
- The UK and the eurozone are facing deteriorating trends and political uncertainties. UK activity weakened due to high inflation and disruption in industry. The BoE is poised to hike rates even further, while the next Prime Minister must choose between giving more support to the economy or restoring public finances.
- The eurozone also faces several risks, with war in Ukraine, disruption in industry, potential energy shortages, high inflation and the end of the ECB's support.
- Several countries are likely to suffer a contraction in the coming quarters, including Germany. Fragmentation risks have been refuelled by the Italian political crisis.
- Moreover, the new ECB Transmission Protection Instrument failed to convince markets that it is a new "whatever it takes" plan with the capacity to avoid major fragmentation risks.

## US-China: diverging strategy and trend

- Recession risks are increasing in the US as domestic demand looks to contract in response to high inflation and rising interest rates. Housing has entered a correction and the outlook for services has deteriorated after its post-Covid rebound.
- In China, firmer activity is expected in H2-22, but Covid cases and the property sector heighten risks while authorities have eased credit and regulation in key sectors.
- The US and China are no longer applying coordinated policies, instead adopting a less cooperative stance. As a result, global growth lacks a major engine to drive activity.

### Deteriorating outlook in Germany

Germany: GDP & IFO




Sources: D. Bundesamt, IFO

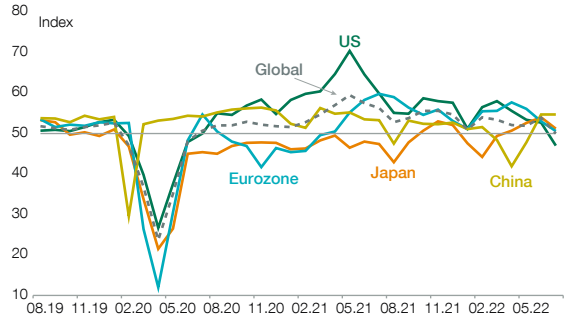
### Accumulated risk weighs down on the outlook of developed countries

| GDP y/y % | 2021 | 2022 | 2023 |
|---|---|---|---|
| WORLD - *MER* | 5.6 | 2.6 | 2.2 |
| *- on PPP basis** | *5.8* | *3.0* | *2.8* |
| USA | 5.7 | 2.0 | 1.0 |
| Japan | 1.8 | 1.8 | 1.0 |
| Eurozone | 5.3 | 2.3 | 1.0 |
| United Kingdom | 7.2 | 3.4 | 1.0 |
| Switzerland | 3.8 | 2.3 | 1.3 |
| Brazil | 4.8 | 1.0 | 1.0 |
| Russia | 4.7 | (11.0) | (2.0) |
| India | 8.5 | 7.0 | 6.0 |
| China | 8.1 | 3.7 | 4.5 |
| Developed countries | 5.1 | 2.3 | 1.1 |
| Emerging countries | 6.3 | 3.3 | 3.7 |

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

### Services: declining confidence in developed countries

Business confidence in services




Source: S&P Global

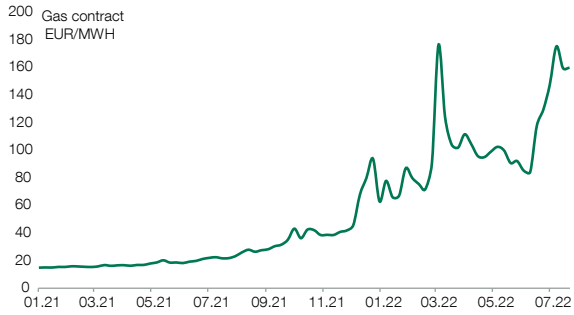
UBP ECONOMIC OUTLOOK

# EU TO FACE MAJOR SHOCK IN CASE OF A GAS SHUT-OFF

- Europe is highly dependent on energy imports from Russia and particularly on its gas. This has become a geopolitical weapon that Russia is deploying in the conflict with Ukraine to put pressure back on Western countries.
- Gas flows from Russia to Europe have been interrupted for regular pipeline maintenance, but risks of a complete gas shut-off are rising ahead of the winter season. Such a scenario would be a major negative shock for European economies.
- Governments have launched proposals to save energy, mainly via lower temperatures in public buildings and recommendations to households. Germany has launched a three-level plan, which rations gas by industry according to their consumption and role in the supply chain, but is looking to protect final consumers. The European Commission (EC) has required energy firms to rebuild gas inventories to 80% by 1 November, which seems challenging due to constraints on the flow through Nord Stream 1.
- Countries, member states and the EC have tried to diversify gas providers (Nordic countries, Middle East, Algeria). However the lack of infrastructure, and countries specialised in LNG such as Germany, increases the challenge of ensuring a regular supply of energy over the next six months and in case of a permanent shortage.
- A gas shortage in Europe will impact Hungary, Slovenia, and Czech Republic (-4% GDP shock) mostly due to their high dependence on Russian energy. Italy will be severely hit (-3.7 pp), as its electricity production is based on gas. According to various IMF-ECB-EC simulations, Austria and Germany will also be affected by around 2% in case of energy shortages.
- If consumers are fully protected from the rise in energy prices and supply constraints, the burden will fall mainly on industry. IMF studies show that if part of the rise in gas prices is passed on to households, the negative impact on the economy is lower, but this requires more budgetary support for low income and fragile households.
- The EC has launched a discussion about reducing gas consumption in member states by 15% over the next six months, implement collective gas purchases and set up a solidarity mechanism for production and distribution across members states, which will have until September to present their energy saving plans by sector.

### Slower gas flows and rising prices fuel downside risks in the Eurozone

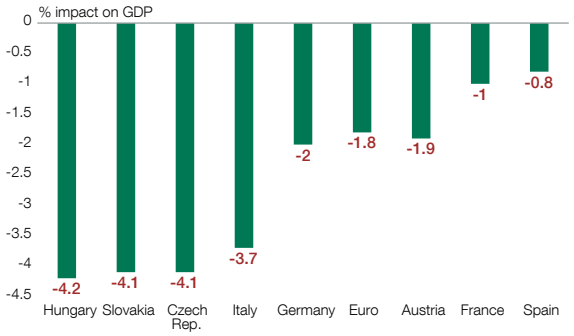
Natural gas prices (Netherlands)




Sources: Bloomberg, UBP

### EU to face a -2 ppt shock on growth in case of a Russian gas shut-off

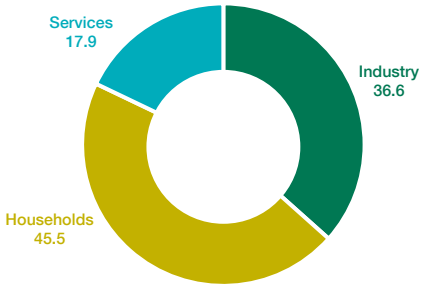
EU: Output losses in case of a Russian gas shut-off




Source: IMF "Natural gas in Europe; potential imact of disruptions to supply" Di Bella; Flanagna; Foda; Maslova, Pienkowski, Stuemern, Toscani WP 22-145 July 2022

### German 3-stage gas emergency plan aims to protect households and essential services

Germany: gas consumption by sector (%)




Sources: German Economics Ministry, UBS

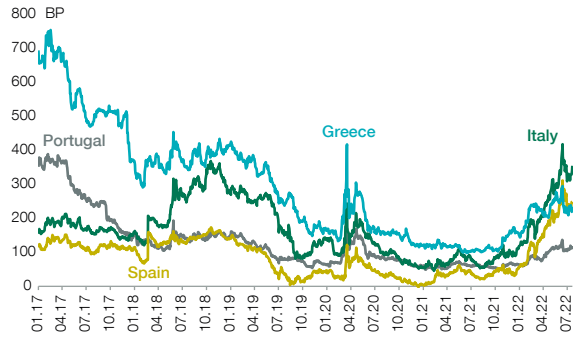
GLOBAL BONDS

# PREFERENCE FOR HEDGE FUNDS AND INVESTMENT GRADE CREDIT

- Weakening economic indicators in the US and the eurozone have fuelled concerns on recession at a time the Fed and the ECB accelerate their adjustment of key rates.
- As a result, 10y government bond yields have eased over the month; US 10y Treasuries came back below 3% and German 10y Bunds declined below 1% at end of July.
- Central banks maintain their inflation fighting unchanged and remain confident on the economy, generating high volatility in 2y government bond yields. In the US, the 2y-10y spread has returned to negative territory, as seen in March, pointing towards another argument in favour of recession risks in addition to falling economic indicators.
- As inflation has not yet passed a significant peak, upside risks could remain in place in government bonds yields. This comes as central banks continue to hike despite weakening PMI in industry and deteriorating trends in labour fuelling more volatility in markets in the short run.
- The ECB has increased its key rates by 50 bp and replaced its forward guidance on rates with a meeting-by-meeting approach, accelerating the exit from negative interest rates. The door remains open to another 50 bp rate hike next September, as the target is to bring key rates close to their "neural" point, indirectly estimated within a 1-1.5% range.
- The ECB has presented its new Transmission Protection Instrument (TPI), which is supposed to avoid fragmentation within the euro area and indirectly to limit pressures on a country from rising spreads on markets.
- This instrument is not limited in amount and conditionality remains low, close to criteria used by the European Commission in its NGEU Recovery Fund. Nevertheless, the TPI will be activated only by an ECB governors' decision, which could delay reaction and limit the possibility of an intervention in case of political or specific pressure on one country such as Italy.
- Credit spreads have eased somewhat over the past weeks but appear set to remain high and volatile with rising recession concerns in the coming months. Fundamentals have deteriorated in Europe and corporate bond spreads have widened in parallel with the more restrictive ECB's policy. A cautious strategy remains in place with a focus on high credit quality. Preference also goes to hedge funds strategies within the fixed income allocation.

### Peripheral spreads in the eurozone under stress

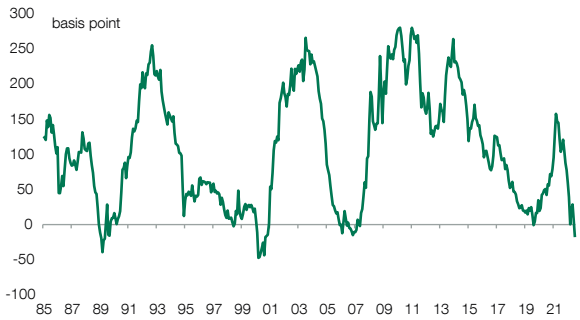
Government bonds (10 y) spreads with Germany




Source: Bloomberg Finance L.P.

### US yield curve has inverted

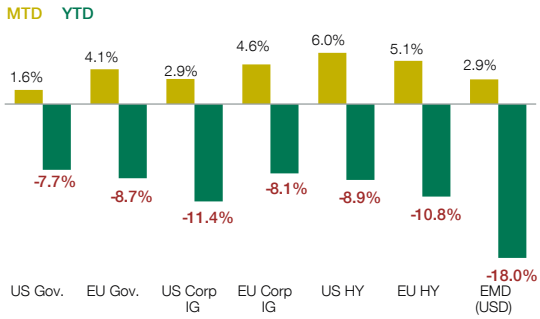
US yield curve (10-year minus 2-year government bond yields)




Source: Bloomberg Finance L.P.

### Positive performance across all segments

Fixed income performance




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

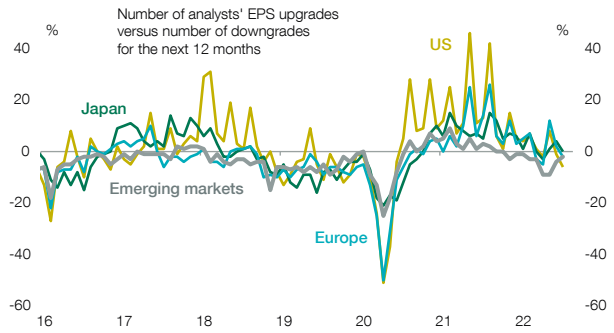
GLOBAL EQUITIES

# EARNINGS ESTIMATES STILL SIGNIFICANTLY TOO HIGH

- Equity markets were supported in July by lower bond yields amid recession fears and rather reassuring Q2 results overall.
- During the first half of the reporting season, US and European companies have reported earnings on average 3-4% ahead of consensus estimates.
- Commentaries with reported results were unsurprisingly cautious, with big differences between companies even in the same industry, but generally came as a relief for many investors.
- Many companies continue to believe that they can proceed with further price increases to offset margin pressures. Some welcome positive developments on the supply chain front were also noted.
- Mixed corporate guidance has finally prompted analysts to lower their earnings estimates for the next 12 months in the US, particularly for next year.
- However, these cuts have remained only moderate so far, and the consensus among analysts continues to expect 9% EPS growth for the S&P 500 index both this year and next.
- For now, estimates for Q3 and Q4, both at 10% (4-6% ex energy) have barely moved with growth forecasts for most sectors down by about 1pp over the last month, offsetting increases for energy.
- We believe that earnings estimates will need to be cut further in the coming weeks, both in the US and in Europe, to reflect a sharp slowdown in activity at a time when raw materials, labour and energy costs still constitute significant headwinds for firms.
- 2022 earnings growth should stay modestly positive but, in our base-case scenario of a mild recession, profits are likely to decline next year as companies will most probably have lost their ability to raise prices, which together with much lower revenue growth, are likely to have a meaningful impact on margins.
- As a result, we remain cautious on equities and keep our asymmetric strategies in place that we implemented during the year.
- In terms of thematic and style, we continue to favour stocks with above-average visibility on earnings streams to cushion against the prospect of downgrades in the months ahead.

### Earnings revision ratios finally negative in most regions

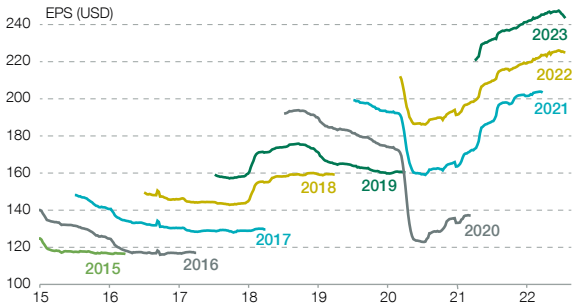
Earnings revision ratio: US, Europe, Japan & EM




Sources: Refinitiv, UBP

### 2023 earnings estimates for US companies have been cut over the last few weeks

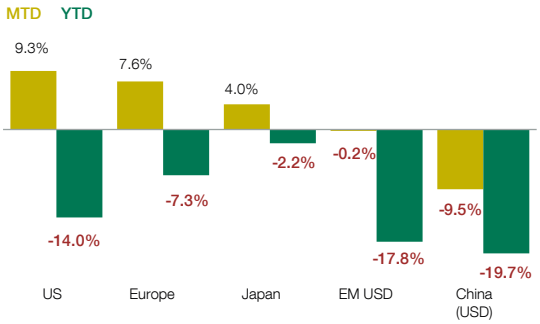
Consensus estimates for S&P 500 EPS by calendar year




Sources: Refinitiv, UBP

### Developed markets rallied led by the US

Equities' performance




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

RECENT CHANGES

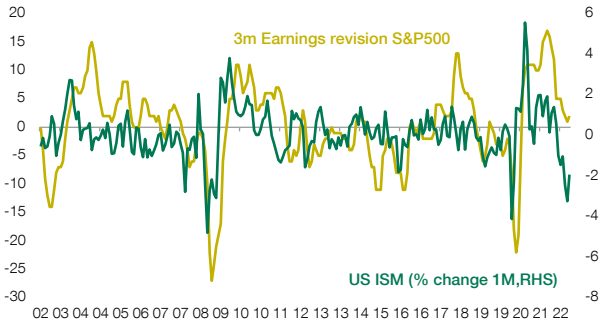
# ADDING GLOBAL MACRO AND CTA STRATEGY INTO HEDGE FUND

- After a correction of -20% of equity markets and -14% of global bonds in the first half of the year, markets rebounded sharply in July on the back of increasing hopes that the US Federal Reserve would slow rate hikes towards the year-end amid recession fears.
- Indeed, recession risk is growing with Europe most exposed due to its high dependence on imported energy. A recession also looks likely in the US.
- However, we do not expect this backdrop to alter actions by central banks at this stage until some clear signs emerge showing that inflation is slowing down, or US job markets start to cool.
- As a result, we keep protection in place through put options and continue to favour asymmetric products in our portfolios such as hedge funds and structured products which provide upside participation while limiting downside risk.
- During the month, we rotated some of equity long-short and credit alternative strategy within hedge fund allocations into global macro / CTA strategy, providing an additional cushion in case of a further equity and credit sell-off.
- Global Macro and CTA are highly opportunistic investment styles that have the potential to generate strong risk-adjusted returns in these challenging markets, as such conditions create attractive trading opportunities on which managers can capitalise.
- In the equity space, we continue to favour companies with high quality earnings visibility and strong balance sheets. They should outperform in an environment of elevated macro uncertainty and mounting profit margin pressure.
- In the fixed income space, although interest rates came off from recent highs, the risk of higher yields and wider spreads remains, especially as the potential for a liquidity and/or prolonged inflationary shock looms. We continue to rely on alternatives in credit arbitrage and absolute return strategies, which are less sensitive to interest rate volatility.
- We maintain our overweight of USD as a hedge against a continued market sell-off. USD usually outperforms during times of market stress.

### Downward earnings revision should continue in the coming months

Earnings revision vs ISM

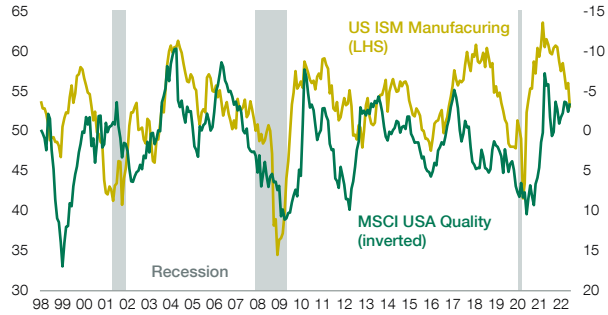
Upwards analyst earnings revisions minus downward as a percentage of total estimates




Sources: Refinitiv, UBP

### Quality companies should outperform in a slowing economy and/or recession

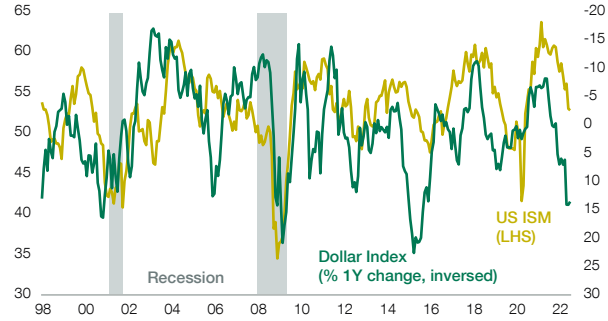
MSCI US Quality vs ISM




Sources: Refinitiv, UBP

### USD is a useful hedge against slowing economy and/or recession

USD vs ISM




Sources: Refinitiv, Datastream, UBP

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