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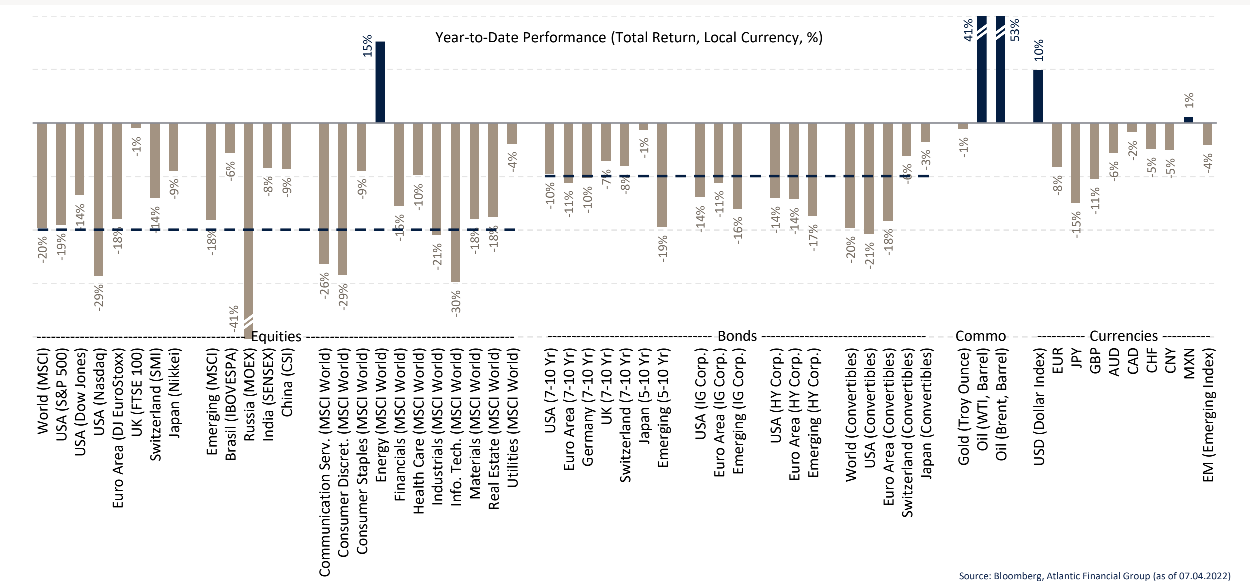
Weekly Investment Focus

11 July 2022

"OUTLOOK FOR A SHAKY END OF YEAR"

- The second semester will not be like the first six months of 2022
- Investors and central bankers will embrace the recession
- Stocks will continue their bear market, while bonds and gold will rebound
- If TINA has disappeared, FOMO remains: the capitulation phase has not yet taken place

CHART OF THE WEEK: "Difficult to hide in the first six months of the year"

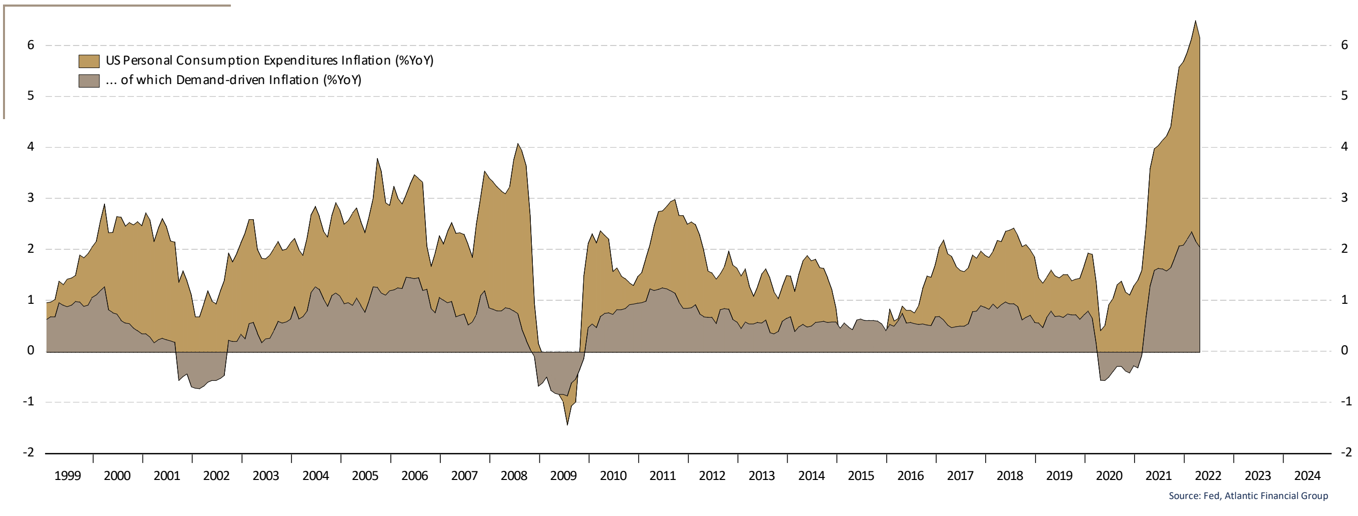


FINANCIAL MARKETS ANALYSIS

The first half of 2022 will remain in the collective memory of investors, as it was so disappointing. On the investment front, most asset classes performed negatively, except for commodities and the greenback (cf. Chart of the Week). In the stock market, the high-water mark was reached at the very end of 2021, which makes comparison even more difficult. As usual in times of crisis, cyclical companies in the InfoTech, consumer discretionary or communication services sectors have underperformed defensive sectors like utilities, consumer staples or healthcare. In the fixed income market, returns were also negative. 10-year US Treasuries, the safe haven investments used as a benchmark to compare the performance of other investments, gave up -10% between 1 January and 30 June. Most other categories of bonds, sovereign and corporate, issued in developed and emerging markets, in local currencies and in dollars, did even worse. Only assets listed in Japan, whose central bank has opted for strict Yield Curve Control (YCC), managed to limit the damage. However, the yen depreciated, falling by -15% against the dollar to its lowest level since September 1998. As for gold, even though it is a raw material and a safe haven, its price failed to rise. At the end of June, it was at the same level as at the beginning of January, at USD 1,814 per ounce.

All these disappointments were predictable, at least in part. In our scenario last November, we detailed the coming economic slowdown and the likelihood of a -22% equity bear market. This has now happened. What's up? Should a rebound be anticipated or, on the contrary, the downside potential be adjusted? **Do not spare the suspense: the bear market is not over; the correction will be stronger than initially expected.** Our 2022 scenario did not include the periods of shutdown in China due to the Covid waves, nor the shortage of raw materials with Russia's invasion of Ukraine, nor the monetary policy mistake when central banks fail to curb inflation linked to a supply shock (see Fig. 2). **These three new difficulties** accentuate the pre-existing tensions of economic stagnation and inflation. **Paradoxically, this "stagflation" will end up favouring a "depression" scenario, a contraction of the words deflation and recession.**

Fig. 2 - Decomposition of US inflation by source: cost-push vs. demand-pull



For some weeks now, **investors have been asking whether a recession will occur in 2023 or 2024. But the recession has already started** in the US (see Fig. 3), in Europe (see Fig. 4), and in many economies. Companies are still buying their raw materials at high prices and are now unable to fill their order books. Under these conditions, they will have no choice but to curb their investments, both in capital and labour. Unemployment will rise, leaving households in difficulty despite recent wage increases. Inflation in goods and services is so high that it is eroding their purchasing power.

Fig. 3 - US business cycle

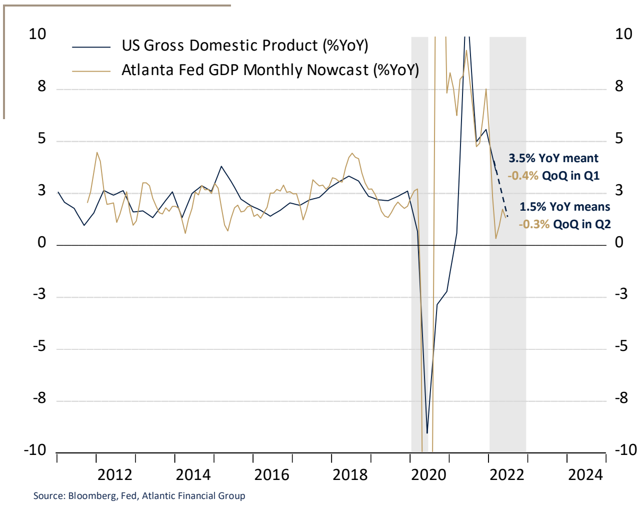
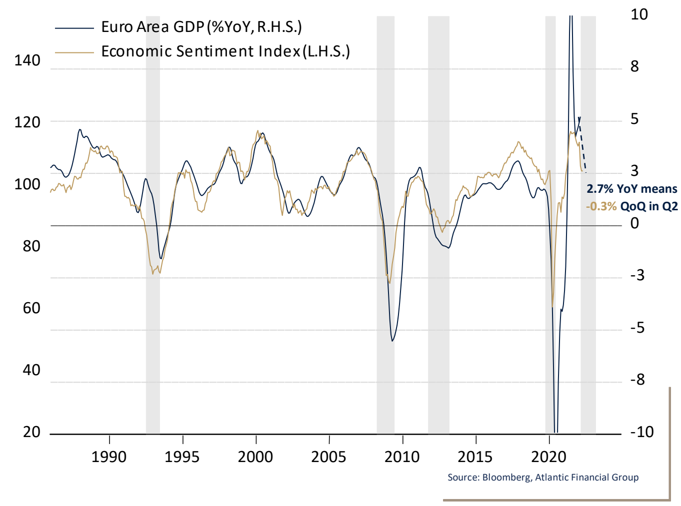


Fig. 4 – Euro Area business cycle



The only good economic news came from China, where the easing of anti-Covid restrictions triggered a rebound in industrial activity. This is the first time in four months (see Fig. 5). The recovery is particularly visible in those sectors that had been affected by the lockdowns. It is also interesting to note that Chinese equities have been outperforming global indices for several weeks (see Fig. 6). This trend is likely to continue.

Fig. 5 - China's economic cycle

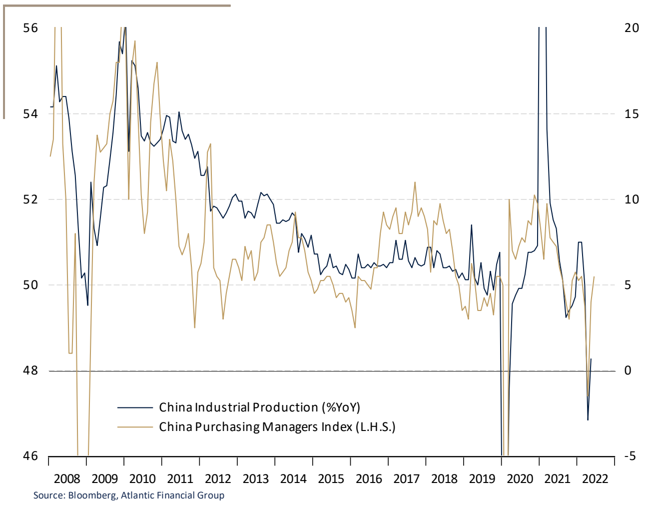
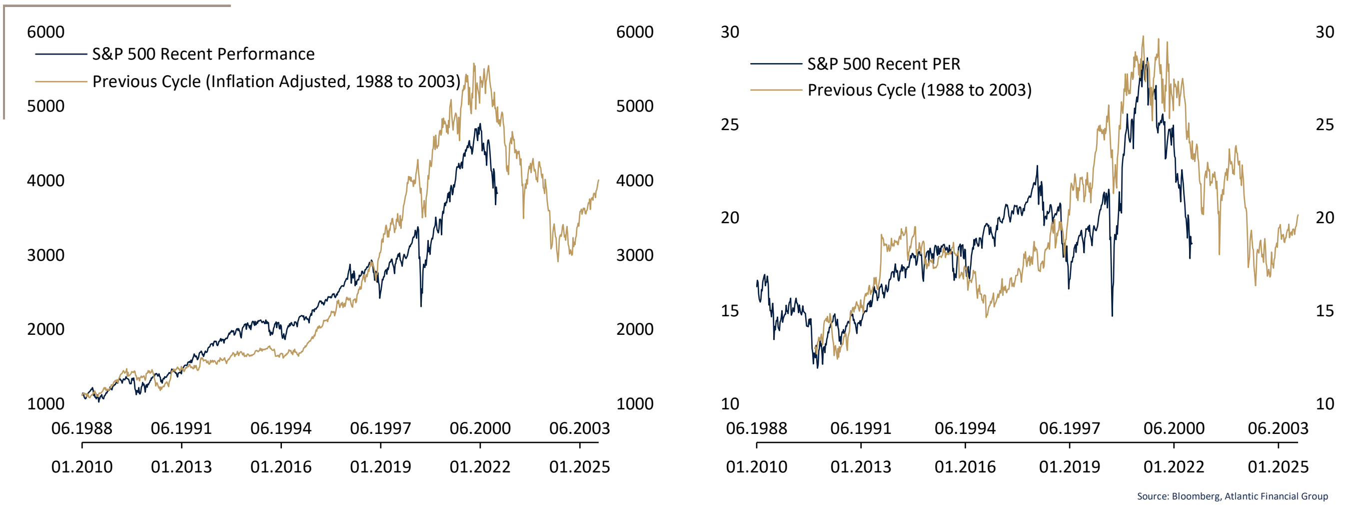


Fig. 6 - Chinese equities' relative performance

Whether in Washington, Frankfurt, London or Bern, central banks are faced with the same dilemma: to bring inflation back to their annual target of 2% or to support the economy as it slows down? In the first half of the year, they clearly chose to respect their mandate to contain inflation expectations, even if it meant generating a recession. **Unfortunately, the cost of this tightening of monetary policy is likely to be much more painful than expected.** Debt, both public and private, has become so large in recent decades that rate hikes have a major impact on debt servicing.

In the second half of the year, central banks should therefore question their anti-inflationary strategy. The European Central Bank (ECB) is already starting to worry about the consequences of its policy on the fragmentation of the Euro Area: if countries like Germany and France are taking the shock, others like Italy and Spain are already under pressure from bond investors. A few weeks ago, Christine Lagarde organised an extraordinary meeting to address the problem of widening credit spreads in the peripheral countries (see Weekly Investment Focus of 20 June 2022). In doing so, the ECB President paved the way for a change in tone and an easing of monetary policy in the Euro Area. In the US, the Fed will certainly be forced to follow the same path in a few months. **The sooner the better if they want to avoid a worst-case scenario.**

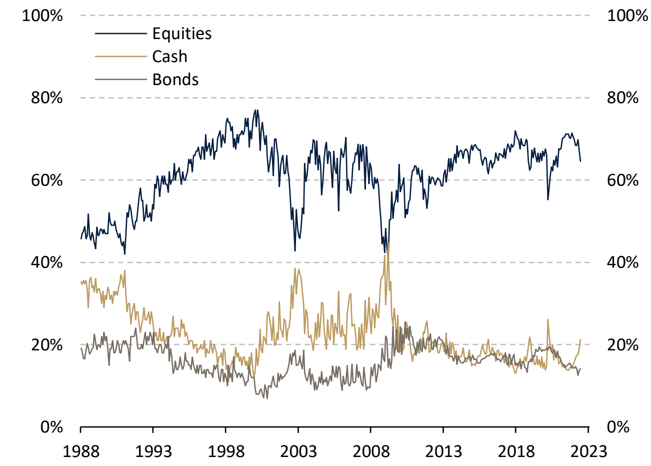
Fig. 7 & 8 - Evolution & valuation of the S&P 500, comparison with the internet bubble



Any good news on the monetary policy front or on the global commodity supply front would be welcomed by investors**. Renewed optimism could lead to a significant rebound** in multiples (see Fig. 8) and, ultimately, **in stock market indices** (see Fig. 7) following the example of the previous long bear market of 2001-2003. However, as usual, this rebound would only be temporary **and would be a bull trap for the most impatient optimistic investors.** Not all the bad news will be in the stock market as yet. This usually takes time. Over the next 12 months, analysts will revise their earnings growth estimates downwards. These estimates are still positive, sometimes even double-digit, when they will end up with red figures.

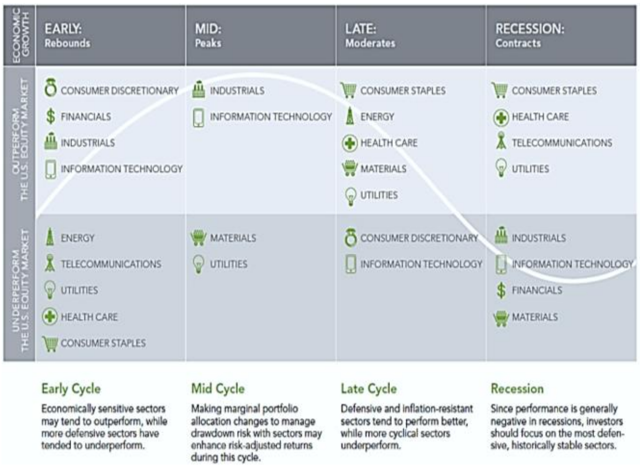
Usually, the bear market bottoms out when investors capitulate. Scared by numerous bearish waves and heavy losses in their equity portfolios, they give up and drastically reduce their allocation to this risky asset. Today, according to the American Association of Individual Investors (AAII), stocks still represent 64.6% of their portfolios. This ratio is down from 71.4% at the end of 2021, but remains well above the levels of 1987, 2001 and 2008. During these three major stock market crises, the allocation to equities briefly drop to 40%, almost at the same level as cash (see Fig. 9).

Fig. 9 - Allocation of individual investors US



Source: AAII, Atlantic Financial Group

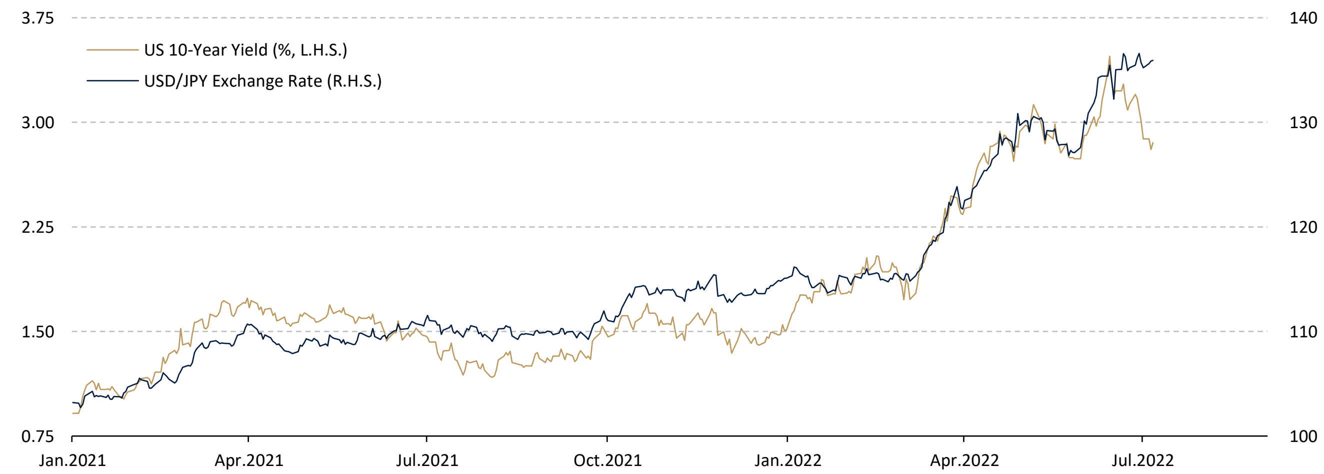
Fig. 10 - Sectors & business cycle



Source: Fidelity, Atlantic Financial Group

Since the rise in bond yields, private investors can no longer say "TINA: There Is No Alternative". Instead, they retain their "FOMO: Fear Of Missing Out". **The anxiety of failing a bull market leads them to hold a high proportion of equities. As long as this is the case,** meaning the capitulation phase has not taken place, **risky assets will fall.** However, in this phase, as we have detailed in recent quarters, defensive will outperform cyclical sectors (see Fig. 10).

Fig. 11 - USD/JPY exchange rate vs. 10-year US bond yield



Source: Bloomberg, Atlantic Financial Group

In the second half of the year, as the recession is going to be discounted, inflationary pressures ease, and central banks soften their rhetoric, **many financial assets will benefit.** First and foremost are **bonds,** whose prices will be boosted by lower yields. Second, and less obviously, investors will welcome the fall in the dollar and, conversely, **the appreciation of currencies such as the yen** (see Fig. 11). In third place, **emerging equities** will outperform US and European indices. Finally, **gold** will gain from a combination of investor anxiety, lower interest rates and a correction in the greenback.

At the current stage of the economic and financial cycle, the decorrelation between equities on the one hand, and bonds and gold on the other, seems to have disappeared. However, nothing is less certain. First, decorrelation does not mean negative correlation. In concrete terms, just because stocks fall (-20%) does not mean that bonds or gold should generate positive returns. By falling less (-10% for bonds) or not at all (0% for gold), they already provide diversification. Second, in the next six months, one of two things will happen:

- Either equities will rebound strongly, and the underperformance of defensive assets will seem insignificant.
- Or, as our scenario suggests, the equity bear market will continue and defensive assets will generate positive returns, possibly in double-digit.

In both cases, by 31 December 2022, **annual performance will certainly show that the decorrelation between stocks, bonds and gold remains.** Lessons should not be drawn before the end of the story.

Conclusion:

The year 2022 will remain in investors' memories. However, the second half of the year should be very different from the first. Performance will be much more mixed. The usual defensive assets, such as bonds, gold, and the yen, will cushion an additional shock to the equity markets.

RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2022 Year-to-Date (%)	2021 (%)	2020 (%)
Equities							
World (MSCI)	608.6	48.36	1.7%	-6.3%	-18.3%	19.0%	16.9%
USA (S&P 500)	3 899	50.50	2.0%	-5.1%	-17.5%	28.7%	18.4%
USA (Dow Jones)	31 338	49.33	0.8%	-4.7%	-12.8%	20.9%	9.7%
USA (Nasdaq)	11 635	53.76	4.6%	-3.7%	-25.3%	22.2%	45.0%
Euro Area (DJ EuroStoxx)	389.5	47.22	1.8%	-7.6%	-16.4%	23.5%	0.8%
UK (FTSE 100)	7 196	47.68	0.5%	-5.0%	-0.6%	18.4%	-11.4%
Switzerland (SMI)	11 015	52.20	2.3%	-3.9%	-12.1%	23.7%	4.3%
Japan (Nikkei)	26 812	48.91	2.2%	-6.0%	-6.9%	6.7%	18.3%
Emerging (MSCI)	1 000	44.18	1.0%	-6.2%	-17.4%	-2.3%	18.8%
Brasil (IBOVESPA)	100 289	42.32	1.3%	-7.5%	-4.3%	-11.9%	2.9%
Russia (MOEX)	2 223	37.91	1.2%	-3.2%	-40.2%	21.9%	14.8%
India (SENSEX)	54 154	59.09	3.0%	-0.6%	-5.7%	23.2%	17.2%
China (CSI)	4 339	59.35	-0.7%	5.7%	-9.3%	-3.5%	29.9%
Communication Serv. (MSCI Worl	83.52	53.04	3.6%	-4.2%	-23.7%	10.9%	24.2%
Consumer Discret. (MSCI World)	301.7	54.18	3.6%	-4.2%	-26.0%	9.2%	37.0%
Consumer Staples (MSCI World)	262.2	52.47	0.1%	-0.5%	-8.8%	11.7%	8.8%
Energy (MSCI World)	207.6	38.78	-2.2%	-20.0%	12.8%	37.5%	-27.7%
Financials (MSCI World)	125.0	42.70	0.4%	-7.4%	-15.2%	25.1%	-3.1%
Health Care (MSCI World)	333.6	58.42	1.2%	-0.1%	-8.7%	18.0%	15.4%
Industrials (MSCI World)	261.6	45.22	0.9%	-8.0%	-20.2%	16.6%	11.8%
Info. Tech. (MSCI World)	417.9	51.33	4.2%	-6.4%	-26.8%	27.6%	46.2%
Materials (MSCI World)	291.8	33.50	-0.5%	-16.2%	-18.3%	15.4%	21.6%
Real Estate (MSCI World)	189.4	45.18	-0.4%	-4.4%	-17.9%	23.6%	-5.7%
Utilities (MSCI World)	150.7	45.72	-1.8%	-5.8%	-5.6%	11.1%	4.8%
Bonds (FTSE)							
USA (7-10 Yr)	3.07%	48.14	-1.3%	0.0%	-10.7%	-2.4%	9.3%
Euro Area (7-10 Yr)	1.98%	52.81	-0.8%	0.6%	-11.9%	-2.9%	4.5%
Germany (7-10 Yr)	1.32%	52.54	-0.3%	0.5%	-10.6%	-2.7%	3.0%
UK (7-10 Yr)	2.23%	50.86	-1.1%	0.3%	-8.2%	-4.9%	5.4%
Switzerland (7-10 Yr)	0.93%	54.99	-0.7%	0.7%	-8.7%	-2.3%	0.4%
Japan (5-10 Yr)	0.24%	56.95	0.1%	0.0%	-1.1%	0.0%	-0.1%
Emerging (5-10 Yr)	7.84%	30.38	-0.9%	-3.3%	-20.1%	-2.3%	5.2%
USA (IG Corp.)	4.71%	46.22	-0.5%	-0.5%	-14.3%	-1.0%	9.9%
Euro Area (IG Corp.)	2.99%	52.26	1.1%	0.1%	-10.7%	-1.0%	2.8%
Emerging (IG Corp.)	7.88%	19.40	-1.0%	-3.5%	-16.9%	-3.0%	8.1%
USA (HY Corp.)	8.59%	42.96	1.3%	-2.7%	-12.9%	5.3%	7.1%
Euro Area (HY Corp.)	7.71%	29.27	0.8%	-4.5%	-13.6%	3.4%	2.3%
Emerging (HY Corp.)	11.75%	19.61	-1.5%	-5.9%	-18.7%	-3.2%	4.3%
World (Convertibles)	355.4	45.92	0.9%	-5.2%	-18.9%	2.4%	38.8%
USA (Convertibles)	476.9	49.16	1.5%	-4.6%	-19.6%	3.1%	54.5%
Euro Area (Convertibles)	3 377	36.97	0.6%	-6.1%	-17.7%	-0.3%	6.1%
Switzerland (Convertibles)	173.7	49.17	-0.5%	-0.7%	-6.6%	-0.5%	0.5%
Japan (Convertibles)	194.1	43.62	0.2%	-2.4%	-3.3%	3.3%	2.8%
Hedge Funds (Crédit Suisse)							
Hedge Funds Indus.	740	71.88	n.a.	-0.6%	n.a.	8.2%	6.4%
Distressed	#N/A N/A	66.22	n.a.	-1.3%	n.a.	12.5%	3.8%
Event Driven	#N/A N/A	59.30	n.a.	-1.3%	n.a.	12.9%	7.0%
Fixed Income	#N/A N/A	63.57	n.a.	0.3%	n.a.	5.2%	3.6%
Global Macro	#N/A N/A	85.52	n.a.	1.6%	n.a.	9.6%	6.5%
Long/Short	#N/A N/A	54.02	n.a.	-0.5%	n.a.	8.3%	7.9%
CTA's	#N/A N/A	77.90	n.a.	-0.1%	n.a.	8.2%	1.9%
Market Neutral	#N/A N/A	31.53	n.a.	1.2%	n.a.	6.2%	1.7%
Multi-Strategy	#N/A N/A	62.03	n.a.	-3.9%	n.a.	7.0%	5.6%
Volatility							
VIX	24.64	39.76	-7.7%	2.8%	43.1%	-24.3%	65.1%
VSTOXX	27.55	47.38	-4.2%	19.1%	43.0%	-17.6%	67.5%
Commodities							
Commodities (CRB)	584.9	n.a.	-0.8%	-8.0%	1.1%	30.3%	10.5%
Gold (Troy Ounce)	1 741	27.07	-3.7%	-7.0%	-4.8%	-3.6%	25.1%
Oil (WTI, Barrel)	104.79	43.77	-3.4%	-14.2%	36.1%	58.7%	-20.5%
Oil (Brent, Barrel)	111.47	44.81	-4.6%	-11.2%	45.9%	51.4%	-23.0%
Currencies (vs USD)							
USD (Dollar Index)	107.43	71.42	2.2%	3.2%	12.3%	6.4%	-6.7%
EUR	1.0138	28.56	-2.7%	-2.6%	-10.8%	-7.5%	9.7%
JPY	137.00	33.99	-1.0%	-1.9%	-16.0%	-10.2%	5.1%
GBP	1.1976	36.76	-1.2%	-1.3%	-11.5%	-1.0%	3.1%
AUD	0.6814	40.16	-0.7%	-1.6%	-6.2%	-5.6%	9.6%
CAD	1.2987	42.64	-1.0%	-0.7%	-2.7%	0.7%	2.1%
CHF	0.9797	39.15	-1.9%	1.8%	-6.8%	-3.0%	9.4%
CNY	6.7119	44.80	-0.2%	0.6%	-5.3%	2.7%	6.7%
MXN	20.540	38.61	-1.3%	-0.4%	-0.1%	-3.0%	-5.0%
EM (Emerging Index)	1 660.4	35.46	-0.2%	-2.0%	-4.3%	0.9%	3.3%

Source: Bloomberg, Atlantic Financial Group

Total Return by asset class (Negative \ Positive Performance)

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