ATLANTIC
FINANCIAL GROUP

Weekly Investment Focus

8 August 2022

"LIKE THE REED IN THE FABLE, GOLD BENDS BUT DOES NOT BREAK"

- The recession will deepen as rate hikes spread through the economy
- Inflation peaks and will become a less serious issue for central banks
- As the yield curve inverts, corporate earnings will contract
- Beyond its strong fundamentals, gold will undertake a technical rebound

CHART OF THE WEEK: "Over the last two years, gold has fluctuated between 1,675 and 2,075"

FINANCIAL MARKETS ANALYSIS

The back-to-back contraction in US activity in the first two quarters of the year has shifted investor fears from inflation to recession. The debate is now whether the US is "technically" or "really" in recession, given that employment growth remains strong. Semantics aside, the second option seems more likely. One sign is the downward trend in leading activity indicators (see Fig. 2). Moreover, consumers may be dipping into their savings to spend as much as before, but the volume of their purchases continues to shrink (see Fig. 3). Employment is a lagging indicator of the business cycle. It always adjusts late, six to

twelve months after productivity gains and business capital expenditures have fallen. Focusing on the labour market to identify a recession is misleading.

Fig. 2 - US economic activity

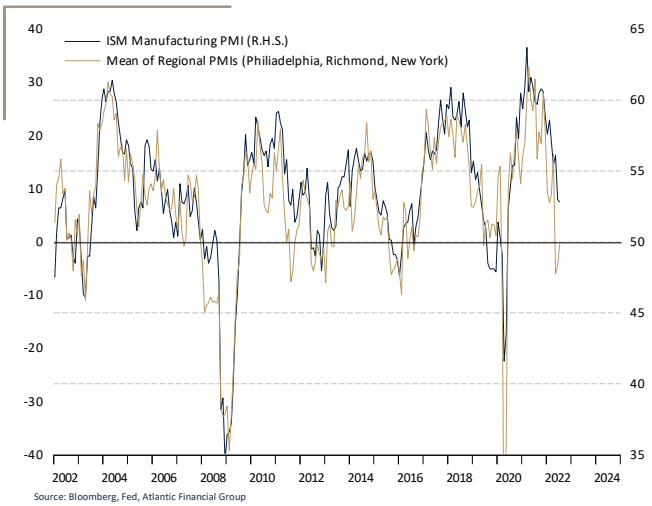
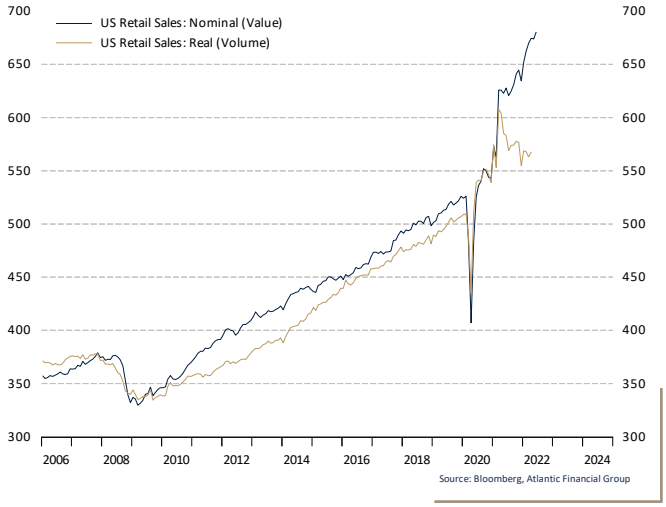


Fig. 3 – US retail sales, by value and volume



Finally, and this is a point underestimated by investors, **the tightening of monetary policy has not yet fully diffused its recessionary effect in the real economy.** It may take a few quarters for the rate hike to be felt by businesses and households. So far, it is mainly the rise in prices that has had an impact on their behaviour. **The recession is therefore likely to deepen and last throughout 2022.**

Inflation is gradually reaching a peak (see Fig. 4). In the main scenario, it will slow down over the next few months and level-off at a lower, although still high, rate. In the alternative, it could even collapse. Inflation is a flow and not a stock: a fall in prices to a lower level than a year ago will result in temporary deflation, even if they remain high in absolute terms.

Fig. 4 – US inflation & expectations

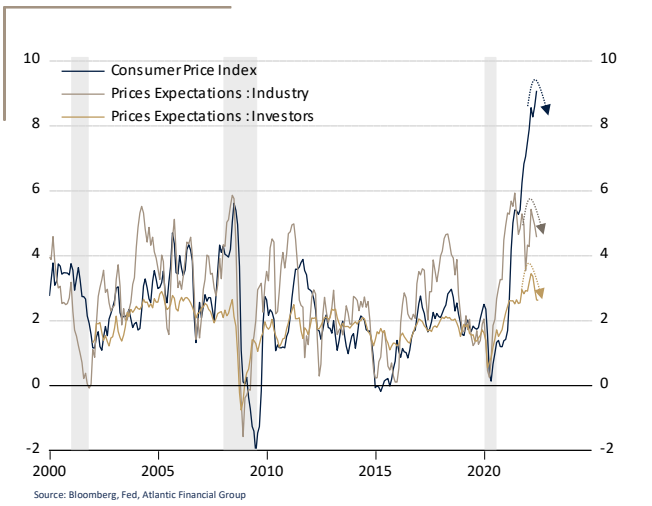
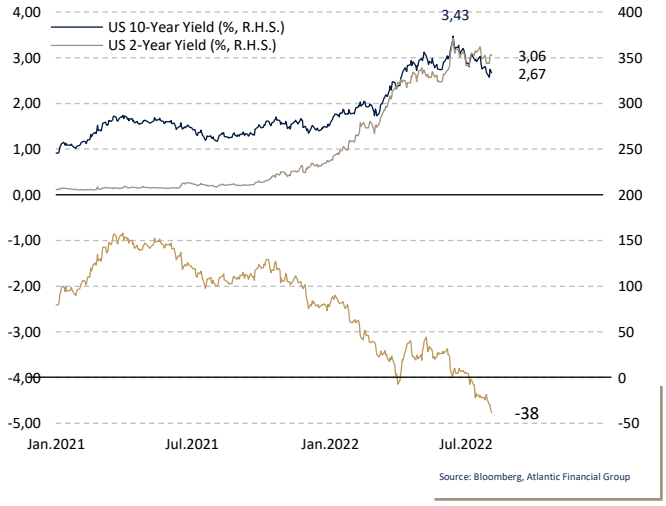


Fig. 5 - US yield curve



On the bond market, the next rate hikes are priced in. **Investors are now watching for signals that would allow the Fed to soften its rhetoric,** whether it be an excessive contraction in activity or a sharp decline in inflation. In this sense, bad news can appear as good news. Central bankers have been criticised for misjudging the post-Covid inflationary period: its strength and duration. They would be equally frowned upon for underestimating the current recession: its strength and duration. They would thus commit a second diagnostic error in less than two years. Under this hypothesis, to enhance their credibility and to avoid a housing crisis, they would be forced to reverse the trend by easing monetary policy rapidly. **For the past month,** the longest bonds have tended to anticipate this scenario and **increasing duration delivers better returns.** This will be the case as long as the yield curve accentuates its inversion (see Fig. 5) and then as it shifts downwards. The steepening will only occur later.

Earnings growth is weakening. It is even close to zero excluding the energy sector, which is performing in line with rising oil and gas prices (see Fig. 6). This downward trend is likely to continue as the economy contracts. The bear market that began in January is therefore not over. **Although institutional investor pessimism has become extreme**, private investor sentiment remains high. Usually, **the capitulation phase only occurs after several disappointments,** several "bull traps". In 2008, for example, fund managers' risk-taking reached its minimum in October (see Fig. 7), six months before the stock market bottom in March 2009.

Fig. 6 – US earnings growth

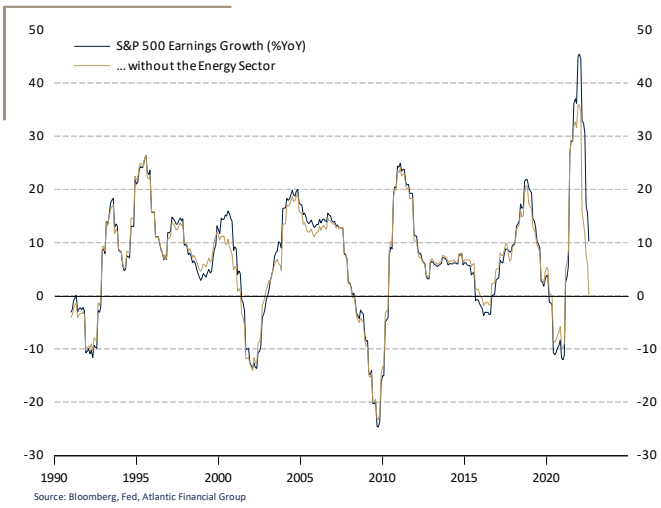
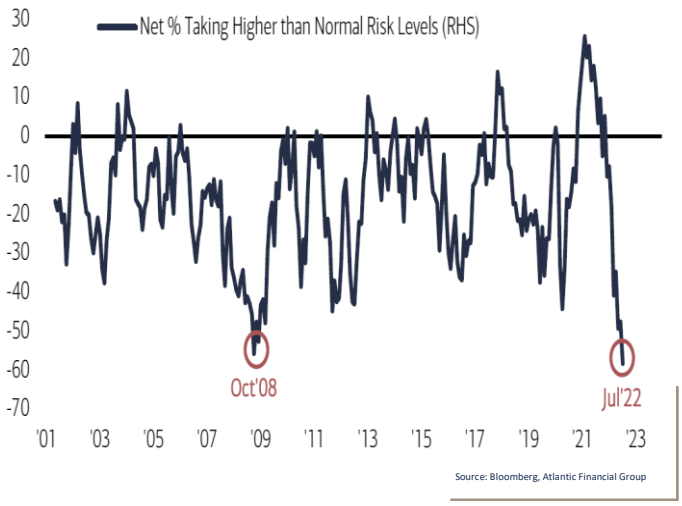


Fig. 7 - Fund managers' risk-taking



The recessionary and disinflationary environment will become increasingly favourable for gold. **The price of an ounce has held up fairly well for the first seven months of the year, stalling while rates rose, and the dollar appreciated.** It could be favoured by investors if these headwinds weaken. Interestingly, gold has hovered in a horizontal range of around 20% during the two Fed rate hike periods, between 2016 and 2018 and again between 2020 and 2022. In contrast, it appreciated by 50% during the intermediate phase of US monetary policy easing (see Chart of the Week). Since gold is denominated in dollars, all other things being equal, it seems logical that it should appreciate when sight deposits pay little interest but depreciate when investors have an alternative source of income. However, in the latter case, it is clear that it moves sideways: it bends but does not break (see Fig. 8). **This asymmetry, which has prevailed for seven years, is sufficiently rare to be noted. It is a bargain for investors.**

Fig. 8 - The Oak, the Reed and the Monnaie de Paris

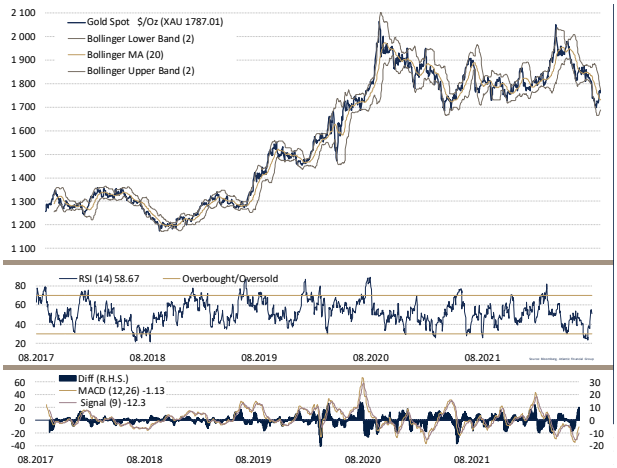
Last year, to pay tribute to and celebrate the 400th anniversary of the fabulist Jean de la Fontaine, the Monnaie de Paris, the institution that mints metal coinage in France, issued a coin whose face depicts the fable "The Oak and the Reed". This coin is in fact a medal, made of an alloy of copper, nickel and aluminium.

The Monnaie de Paris would have done better to produce the 20,000 copies of this coin in physical gold because, like the reed and the moral of the fable, the price of an ounce of gold "bends but does not break" during periods of strong winds.

Source: Monnaie de Paris, Atlantic Financial Group

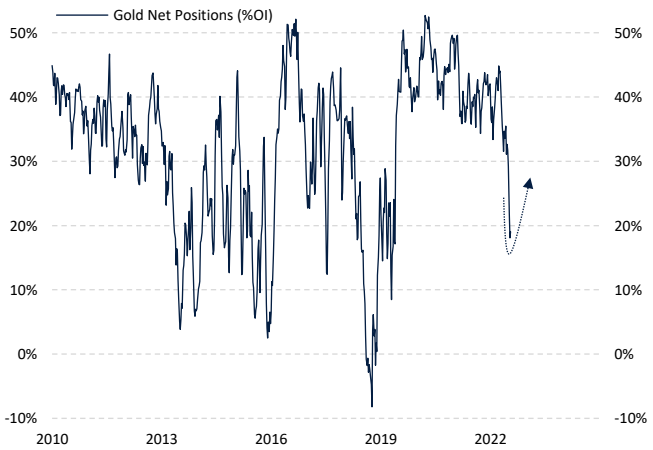
Technically, beyond its regularly mentioned strong fundamentals and unique portfolio diversification power, support at $1,675 looks solid. In parallel, trend-following, momentum, or signal strength indicators, such as the MACD and RSI (see Fig. 9), are ideally positioned to amplify a rebound in the ounce. Finally, the latest data on traders' positioning shows that they have drastically reduced their purchases in recent months, reaching one of the lowest long positions: 18% compared to 30% on average (see Fig. 10). Traders will soon have no choice but to jump back into the market to participate in the upside and avoid seeing the performance of their funds suffer from this temporary under-exposure. **All these technical elements are favourable to a rapid movement in gold prices.**

Fig. 9 - Momentum indicators



Source: Bloomberg, Fed, Atlantic Financial Group

Fig. 10 - Speculative gold positions



Source: Bloomberg, Atlantic Financial Group

The gold mining sector regularly offers leverage to the price of gold, but its correlation remains very strong. It is therefore no surprise that its good performance in the first quarter was fully erased between April and July. Worse still, the gold mining tracker tended to underperform both the gold price (see Fig. 11) and the overall equity market (see Fig. 12).

Fig. 11 - Gold prices and sector index

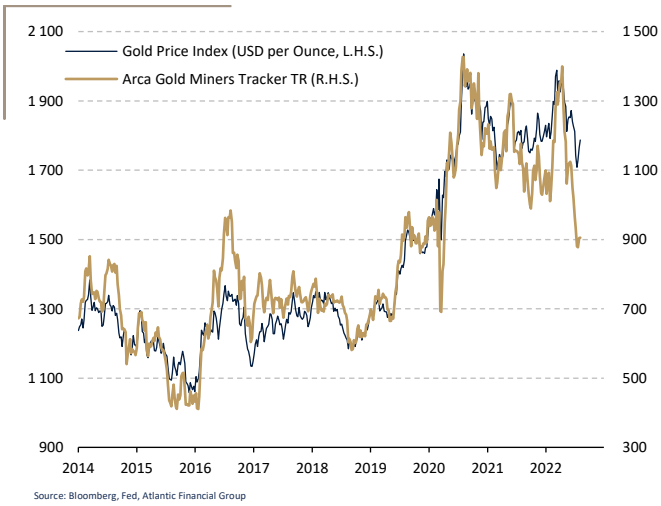
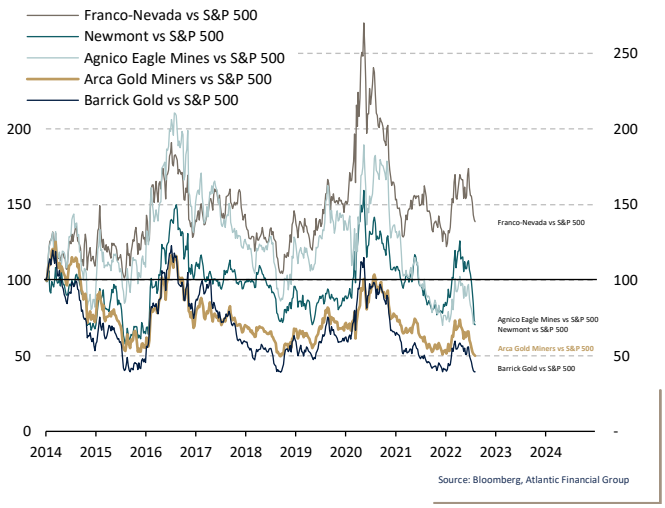


Fig. 12 - Relative performance of gold mines



The recent rebound in gold and its potential upside should allow the companies in this sector to catch up with the market. **The outperformance should be even more visible for large caps, including Newmont Mining, Barrick Gold, Franco Nevada or Agnico Eagle Mines,** which have suffered more than smaller gold miners.

Conclusion:

The recession is taking hold and, depending on its strength and duration, could provide a new excuse for investors to criticise current monetary policy. The bond market seems to indicate that after underestimating inflation, by refuting the recession, central banks are making a second diagnostic error in less than two years. In the stock market, the earnings contraction will turn rallies into bull traps until the capitulation phase sets in. This environment will become increasingly favourable for gold and gold miners. As good news never comes alone, technical analysis offers them strong support and momentum to bounce back.

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)	639.5	64.36	0.3%	7.1%	-14.1%	19.0%	16.9%
USA (S&P 500)	4 145	64.48	0.4%	8.3%	-12.3%	28.7%	18.4%
USA (Dow Jones)	32 803	61.81	-0.1%	6.0%	-8.7%	20.9%	9.7%
USA (Nasdaq)	12 658	66.71	2.2%	11.8%	-18.7%	22.2%	45.0%
Euro Area (DJ EuroStoxx)	411.0	61.96	0.3%	10.3%	-11.7%	23.5%	0.8%
UK (FTSE 100)	7 440	61.78	0.4%	6.2%	3.0%	18.4%	-11.4%
Switzerland (SMI)	11 123	53.31	-0.2%	3.9%	-11.3%	23.7%	4.3%
Japan (Nikkei)	28 249	64.35	0.4%	6.8%	-1.9%	6.7%	18.3%
Emerging (MSCI)	1 003	55.12	1.0%	1.6%	-16.9%	-2.3%	18.8%
Brasil (IBOVESPA)	106 472	70.10	3.2%	8.3%	1.6%	-11.9%	2.9%
Russia (MOEX)	2 054	34.81	-7.2%	-6.7%	-44.4%	21.9%	14.8%
India (SENSEX)	58 696	75.55	1.5%	10.1%	1.2%	23.2%	17.2%
China (CSI)	4 139	42.37	-2.9%	-8.1%	-15.5%	-3.5%	29.9%
Communication Serv. (MSCI Worl	82.55	52.79	1.1%	0.6%	-24.6%	10.9%	24.2%
Consumer Discret. (MSCI World)	326.7	64.18	1.2%	10.8%	-19.8%	9.2%	37.0%
Consumer Staples (MSCI World)	267.9	57.00	-0.4%	3.1%	-6.7%	11.7%	8.8%
Energy (MSCI World)	214.6	48.88	-5.0%	4.6%	16.7%	37.5%	-27.7%
Financials (MSCI World)	129.7	60.14	0.2%	5.4%	-11.8%	25.1%	-3.1%
Health Care (MSCI World)	334.5	53.77	-0.9%	1.8%	-8.4%	18.0%	15.4%
Industrials (MSCI World)	282.9	67.86	0.4%	10.5%	-13.6%	16.6%	11.8%
Info. Tech. (MSCI World)	460.3	68.88	2.2%	13.7%	-19.3%	27.6%	46.2%
Materials (MSCI World)	302.6	55.10	-0.8%	5.5%	-15.2%	15.4%	21.6%
Real Estate (MSCI World)	196.1	59.27	-1.5%	4.0%	-14.9%	23.6%	-5.7%
Utilities (MSCI World)	158.2	65.10	0.0%	6.3%	-0.7%	11.1%	4.8%
Bonds (FTSE)							
USA (7-10 Yr)	2.81%	51.54	-1.4%	0.1%	-8.7%	-2.4%	9.3%
Euro Area (7-10 Yr)	1.58%	59.00	-0.4%	2.6%	-9.0%	-2.9%	4.5%
Germany (7-10 Yr)	0.92%	56.60	-0.9%	2.3%	-8.0%	-2.7%	3.0%
UK (7-10 Yr)	2.05%	48.78	-1.5%	0.2%	-6.9%	-4.9%	5.4%
Switzerland (7-10 Yr)	0.56%	58.76	-0.8%	2.1%	-6.2%	-2.3%	0.4%
Japan (5-10 Yr)	0.17%	75.16	0.1%	0.9%	-0.3%	0.0%	-0.1%
Emerging (5-10 Yr)	7.42%	66.99	0.1%	4.0%	-17.0%	-2.3%	5.2%
USA (IG Corp.)	4.51%	52.73	-1.5%	2.3%	-12.4%	-1.0%	9.9%
Euro Area (IG Corp.)	2.52%	60.12	-0.8%	2.8%	-8.2%	-1.0%	2.8%
Emerging (IG Corp.)	7.52%	55.81	-0.6%	1.4%	-15.7%	-3.0%	8.1%
USA (HY Corp.)	7.61%	74.17	0.3%	5.0%	-8.5%	5.3%	7.1%
Euro Area (HY Corp.)	6.45%	78.20	0.5%	5.0%	-9.3%	3.4%	2.3%
Emerging (HY Corp.)	11.03%	65.99	0.5%	3.9%	-15.5%	-3.2%	4.3%
World (Convertibles)	371.7	71.34	1.6%	5.5%	-15.2%	2.4%	38.8%
USA (Convertibles)	501.1	70.27	2.1%	6.1%	-15.5%	3.1%	54.5%
Euro Area (Convertibles)	3 606	74.39	0.4%	8.3%	-12.2%	-0.3%	6.1%
Switzerland (Convertibles)	175.3	54.69	-0.4%	0.6%	-5.7%	-0.5%	0.5%
Japan (Convertibles)	196.3	59.71	0.4%	1.0%	-2.2%	3.3%	2.8%
Hedge Funds (Crédit Suisse)							
Hedge Funds Indus.	725	63.85	n.a.	-2.1%	n.a.	8.2%	6.4%
Distressed	930	43.79	n.a.	-2.4%	n.a.	12.5%	3.8%
Event Driven	750	49.89	n.a.	-3.6%	n.a.	12.9%	7.0%
Fixed Income	382	54.88	n.a.	-1.9%	n.a.	5.2%	3.6%
Global Macro	1420	76.63	n.a.	-3.1%	n.a.	9.6%	6.5%
Long/Short	852	47.73	n.a.	-2.8%	n.a.	8.3%	7.9%
CTA's	405	51.23	n.a.	1.1%	n.a.	8.2%	1.9%
Market Neutral	287	59.28	n.a.	-1.1%	n.a.	6.2%	1.7%
Multi-Strategy	687	52.13	n.a.	-1.8%	n.a.	7.0%	5.6%
Volatility							
VIX	21.15	38.25	-0.8%	-23.2%	22.8%	-24.3%	65.1%
VSTOXX	22.85	40.39	2.5%	-27.7%	18.6%	-17.6%	67.5%
Commodities							
Commodities (CRB)	583.1	n.a.	0.1%	0.1%	0.8%	30.3%	10.5%
Gold (Troy Ounce)	1 774	54.27	0.1%	1.8%	-3.0%	-3.6%	25.1%
Oil (WTI, Barrel)	89.01	34.39	-5.2%	-10.5%	15.6%	58.7%	-20.5%
Oil (Brent, Barrel)	99.45	38.90	-9.4%	-10.9%	26.2%	51.4%	-23.0%
Currencies (vs USD)							
USD (Dollar Index)	106.56	52.62	1.1%	-0.4%	11.4%	6.4%	-6.7%
EUR	1.0181	45.49	-0.8%	0.0%	-10.5%	-7.5%	9.7%
JPY	135.39	48.70	-2.8%	0.5%	-15.0%	-10.2%	5.1%
GBP	1.2077	47.68	-1.4%	0.4%	-10.8%	-1.0%	3.1%
AUD	0.6935	50.83	-1.3%	1.1%	-4.5%	-5.6%	9.6%
CAD	1.2917	47.66	-0.6%	0.2%	-2.2%	0.7%	2.1%
CHF	0.9609	52.72	-1.2%	1.7%	-5.0%	-3.0%	9.4%
CNY	6.7611	42.69	0.1%	-1.0%	-6.0%	2.7%	6.7%
MXN	20.395	50.85	-0.1%	0.3%	0.7%	-3.0%	-5.0%
EM (Emerging Index)	1 661.6	53.26	0.0%	0.1%	-4.2%	0.9%	3.3%

Source: Bloomberg, Atlantic Financial Group

Total Return by asset class (Negative \ Positive Performance)

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