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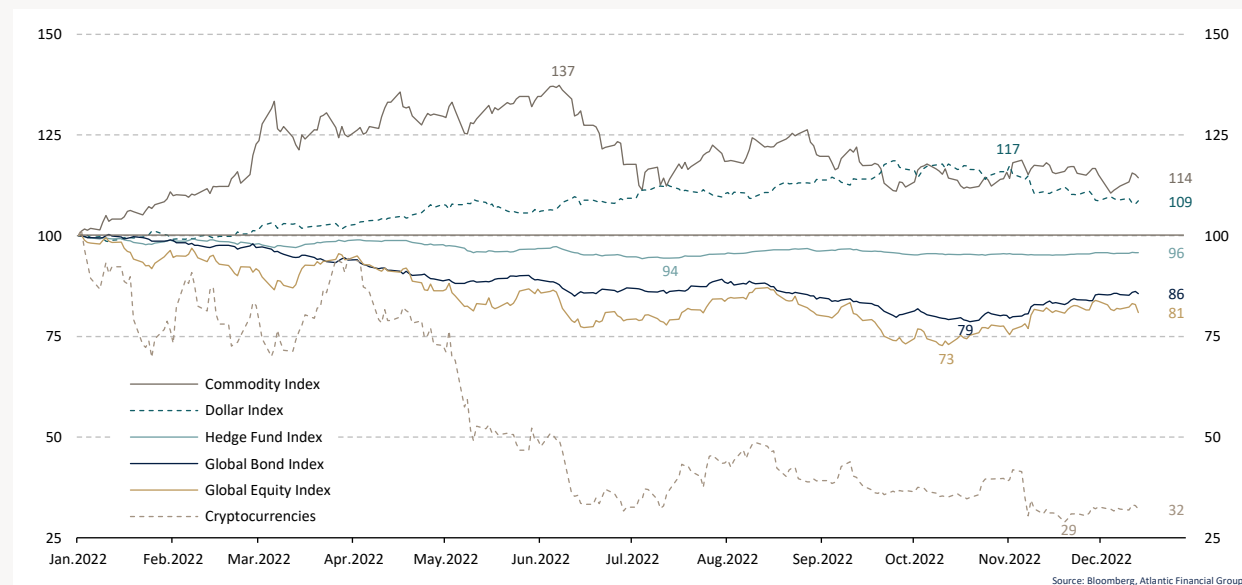
Weekly Investment Focus

19 December 2022

"2022 ENDS BUT WILL NEVER BE FORGOTTEN"

- ◆ The performance of the balanced portfolios is negative
- ◆ The 60/40 diversification did not cushion the shock as much as usual
- ◆ As inflation returns, investors are concerned about "real" performance
- ◆ As bond yields rise, illiquid private assets look less attractive

CHART OF THE WEEK: "Return on asset classes year to date"



FINANCIAL MARKETS ANALYSIS

In 2022, the downturn in the financial markets will have been painful for investors. The MSCI World Equity Index is down -19%, having fallen -27% in October (see Chart of the Week). Equities are not the only ones to have experienced a bear market. Volatile assets such as cryptocurrencies have been battered: their capitalisation has fallen to \$870 billion after having jumped to almost \$3 trillion a year ago, down -68%. The safest assets did not escape the rout either. The global bond index fell by -14% in 2022, with a trough at -21%.



Taken individually, these losses are significant, but more importantly, it is the correlation between them that has made their impact punishing for investors. The "60/40 portfolio", composed of 60% equities and 40% bonds, is a popular choice for investors who are looking for a good return without taking too much risk. **This year, with a performance of -15% (see Fig. 2), this strategy is disappointing.** Discretionary management shows very similar results, with slightly less volatility, including for portfolios balanced in euros (see Fig. 3) that were able to benefit from the 9% appreciation of the dollar.

Fig. 2 - Performance of 60/40 portfolios in USD

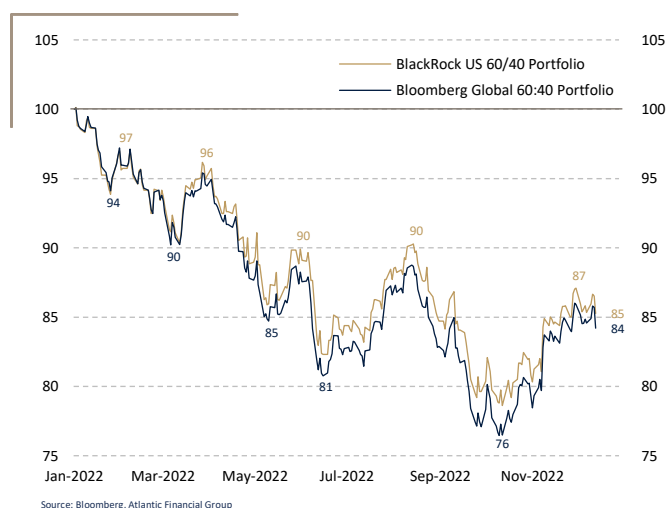
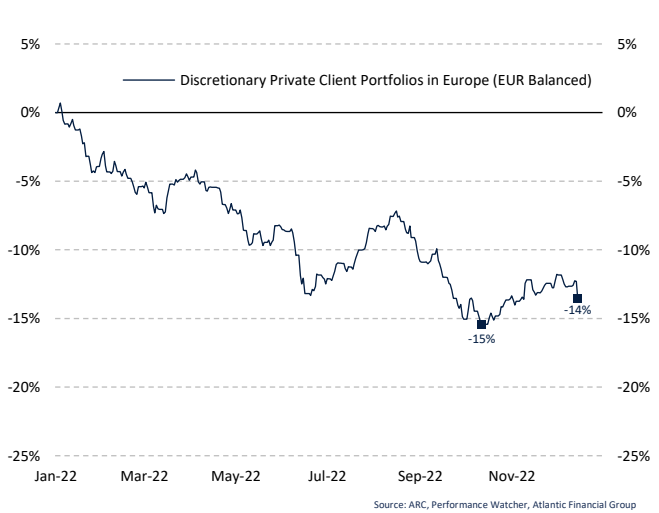


Fig. 3 - Performance of balanced portfolios in EUR



Investors have had few places to hide this year. Those who chose to be more cautious by allocating more bonds did not benefit. As for other "safe haven" assets, they offered only limited protection. Cash did not bring in much, even if its return is starting to become attractive. Gold, considered not only as a protection against the uncertainties of the financial markets but also against inflation, fell by -4%. Even the Japanese yen, which usually rises when risk increases, fell by -10%, passing through a low of -23%. **In the end, only investments in the dollar and commodities** (see Chart of the Week), most of which saw their prices soar following Russia's invasion of Ukraine in February, **were profitable.**

This widespread fall in financial markets is the result of a change in the macroeconomic regime. Inflation, which has not been seen at such a high level in the developed world since the 1980s, is back... and it is visible. **Investors are now looking to protect their portfolios from inflation,** from being eroded in "real" terms. Whereas this objective had become a secondary concern, they are now favouring investments in "real" assets, such as commodities. As a frequent source of inflation, commodities are a good way to protect against it. Moreover, commodities are now much more "financialised" than in the 1970s, with deep and liquid futures market. This means that investors can easily gain exposure to them without the risk of having barrels of oil or bushels of wheat physically delivered.

The return of inflation has also changed the work of central bankers, who are trying to put an end to fifteen years of exceptional monetary policies. Since the beginning of the year, central banks have sought



to move away from zero interest rates and money printing, the now famous Quantitative Easing, in order to normalise their monetary policy. Last week, the Fed, the ECB, the BoE and the SNB all raised their key rates by a further 50 basis points and confirmed their programmes to reduce their balance sheets. The speeches that followed these meetings were all hawkish, including that of the Federal Reserve (see Fig. 4), much to investors' dismay.

Fig. 4 - Commentary on central banks

In his latest policy speech, the Fed chairman reiterated that the US central bank still has work to do to battle against inflation, i.e. that its policy of raising interest rates is not over. Jerome Powell attempted to dismiss any option that the Fed would become more accommodative, despite falling price pressures and growing fears of job losses and recession.

Equity investors were disappointed, with major indices falling on the announcement. Bond investors, meanwhile, are sending a clear signal that Jerome Powell's speech is not credible in the long run. While the 2-year rate rose slightly, the 10-year weakened, a sign that the decline in economic activity and inflation will soon force the Fed chairman to change his stance and support economic players: governments, corporates, and households.

Outside the US, the rhetoric of central bankers is very similar. It is interesting to note how radically they have modified their strategy. Whereas for decades they have sought to avoid overheating and dampen the downturn, they are now doing the exact opposite. During the lockdown easing, they sought to accelerate the growth of activity and prices. Now they are embracing a sharp slowdown. Former New York Fed President, William Dudley, recently argued that central bankers need to slow the economy enough to ease the labour market and drive down wages to a level consistent with 2% inflation. The Bank of England's Deputy Governor, Jon Cunliffe, said that UK house prices could fall by -20% without most homeowners suffering.

Having underestimated inflationary pressures, central bankers are now downplaying the risk of economic and financial crisis and overestimating their ability to make a soft landing. They have the weakness of believing that they can stop the job losses and the housing crisis whenever they want. Worse, they are underestimating the liquidity and solvency risks that are emerging from this rapid tightening of monetary policy. **Our scenario for 2023 is getting stronger: central banks will pivot abruptly when they have "broken something", after a "Lehman moment", i.e. when they have no choice.**

Source: Atlantic Financial Group

Rising sovereign bond yields have made risky assets less attractive. This is the case for equities, and also for private markets. These investment strategies (such as private debt, private equity, direct real estate, or all strategies related to trade finance, infrastructure, litigation, or life settlements for example) have grown massively over the last few years. Institutional investors have been particularly enthusiastic. US public pension funds, for example, allocate almost 20% of their portfolios to private equity and real estate. This ratio is expected to decline in the near future. At a time when it is possible to obtain a 4% return on government bonds, the managers of these funds are wondering whether the 7% expected on private assets is sufficient. With such close performance prospects, the illiquidity of private assets, and even their opacity in some cases, works against them.

In 2023, some private assets may be impaired. It is usually up to the managers who manage the fund's assets to value them. They are naturally reluctant to write them down. In the first three quarters of 2022, Lincoln International Bank estimated that private equity funds worldwide increased the value of the



companies they hold by +3%, even as the S&P 500 lost -22%. However, such inertia will lead to poor returns in the years to come, as it will be difficult, if not impossible, to sell assets at unrealistically high valuations at a profit. Private debt funds face a different problem. While they generally have floating interest rates and their value increases as rates rise, many of them specialise in distressed companies. They will therefore face defaults as debt service becomes more expensive.

As usual in such situations, the best will emerge stronger while the worst will disappear. Funds that were looking to generate organic growth will do very well. On the other hand, those that made money only through capital leverage (LBO) will be the most at risk.

Conclusion:

Investors are concerned, and rightly so, about the hawkishness of central banks and its impact on economic agents, financial markets, and investment funds. After a year of high correlation between assets in 2022, 2023 will be the year of diversification. High returns on bonds make risky investments, such as equities, or illiquid investments, such as private assets, less attractive considering the risks involved. The next twelve months will be no less extraordinary than the last. Happy New Year!



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)	606.1	44.03	-2.1%	-1.5%	-17.9%	19.0%	16.9%
USA (S&P 500)	3 852	42.01	-2.1%	-2.5%	-17.9%	28.7%	18.4%
USA (Dow Jones)	32 920	43.01	-1.6%	-1.6%	-7.5%	20.9%	9.7%
USA (Nasdaq)	10 705	41.12	-2.7%	-4.2%	-31.0%	22.2%	45.0%
Euro Area (DJ EuroStoxx)	410.1	41.48	-3.2%	-1.7%	-11.5%	23.5%	0.8%
UK (FTSE 100)	7 332	40.98	-1.9%	0.0%	2.8%	18.4%	-11.4%
Switzerland (SMI)	10 770	38.39	-2.7%	-1.5%	-14.0%	23.7%	4.3%
Japan (Nikkei)	27 245	44.19	-1.3%	-1.8%	-2.4%	6.7%	18.3%
Emerging (MSCI)	957	53.10	-2.1%	0.6%	-19.9%	-2.3%	18.8%
Brasil (IBOVESPA)	102 856	32.61	-4.3%	-6.7%	-1.9%	-11.9%	2.9%
Russia (MOEX)	2 133	40.09	-2.0%	-4.1%	-39.0%	21.9%	14.8%
India (SENSEX)	61 588	43.46	-1.4%	-1.0%	6.6%	23.2%	17.2%
China (CSI)	3 906	60.62	-1.0%	3.2%	-18.2%	-3.5%	29.9%
Communication Serv. (MSCI World)	70.16	42.71	-2.6%	-3.0%	-35.5%	10.9%	24.2%
Consumer Discret. (MSCI World)	283.9	42.17	-3.3%	-2.6%	-30.0%	9.2%	37.0%
Consumer Staples (MSCI World)	266.5	48.72	-1.6%	1.5%	-6.4%	11.7%	8.8%
Energy (MSCI World)	232.0	38.18	0.2%	-7.2%	29.5%	37.5%	-27.7%
Financials (MSCI World)	129.4	42.40	-2.1%	-2.1%	-11.2%	25.1%	-3.1%
Health Care (MSCI World)	341.0	49.34	-1.6%	2.3%	-6.1%	18.0%	15.4%
Industrials (MSCI World)	283.6	47.69	-1.6%	-0.2%	-12.7%	16.6%	11.8%
Info. Tech. (MSCI World)	402.5	43.54	-2.7%	-3.5%	-29.1%	27.6%	46.2%
Materials (MSCI World)	311.7	47.32	-3.1%	-0.7%	-11.1%	15.4%	21.6%
Real Estate (MSCI World)	173.5	47.45	-1.8%	0.4%	-23.7%	23.6%	-5.7%
Utilities (MSCI World)	150.4	51.05	-1.0%	2.1%	-4.6%	11.1%	4.8%
Bonds (FTSE)							
USA (7-10 Yr)	3.52%	63.21	0.8%	2.6%	-12.0%	-2.4%	9.3%
Euro Area (7-10 Yr)	2.91%	37.17	-2.4%	-1.7%	-17.1%	-2.9%	4.5%
Germany (7-10 Yr)	2.15%	38.52	-1.8%	-0.6%	-15.8%	-2.7%	3.0%
UK (7-10 Yr)	3.33%	45.73	-1.2%	-1.3%	-15.3%	-4.9%	5.4%
Switzerland (7-10 Yr)	1.28%	41.99	-1.1%	-0.8%	-10.1%	-2.3%	0.4%
Japan (5-10 Yr)	0.26%	40.72	-0.1%	-0.4%	-1.5%	0.0%	-0.1%
Emerging (5-10 Yr)	7.74%	69.66	0.3%	4.4%	-16.3%	-2.3%	5.2%
USA (IG Corp.)	5.11%	65.66	0.5%	3.5%	-13.7%	-1.0%	9.9%
Euro Area (IG Corp.)	4.02%	45.96	-1.0%	0.3%	-12.5%	-1.0%	2.8%
Emerging (IG Corp.)	7.83%	82.03	0.6%	5.1%	-14.8%	-3.0%	8.1%
USA (HY Corp.)	8.56%	59.50	-0.1%	1.8%	-10.0%	5.3%	7.1%
Euro Area (HY Corp.)	7.80%	52.82	-0.4%	0.8%	-10.3%	3.4%	2.3%
Emerging (HY Corp.)	10.94%	73.32	0.4%	4.6%	-12.2%	-3.2%	4.3%
World (Convertibles)	360.4	49.17	-0.4%	-0.2%	-17.8%	2.4%	38.8%
USA (Convertibles)	478.5	45.65	-0.5%	-1.0%	-19.3%	3.1%	54.5%
Euro Area (Convertibles)	3 534	49.79	-0.3%	0.2%	-13.9%	-0.3%	6.1%
Switzerland (Convertibles)	174.0	51.17	-0.6%	0.4%	-6.4%	-0.5%	0.5%
Japan (Convertibles)	198.9	50.91	0.0%	0.4%	-0.9%	3.3%	2.8%
Hedge Funds (Crédit Suisse)							
Hedge Funds Indus.	734	62.96	n.a.	0.3%	1.0%	8.2%	6.4%
Distressed	924	53.46	n.a.	-0.5%	-4.5%	12.5%	3.8%
Event Driven	758	49.00	n.a.	0.9%	-6.7%	12.9%	7.0%
Fixed Income	384	53.95	n.a.	0.3%	-2.3%	5.2%	3.6%
Global Macro	1412	65.33	n.a.	-4.9%	17.1%	9.6%	6.5%
Long/Short	872	47.36	n.a.	3.7%	-5.5%	8.3%	7.9%
CTA's	403	66.60	n.a.	-4.6%	18.0%	8.2%	1.9%
Market Neutral	290	59.13	n.a.	1.6%	-0.1%	6.2%	1.7%
Multi-Strategy	709	63.60	n.a.	1.1%	1.7%	7.0%	5.6%
Volatility							
VIX	22.62	49.12	-0.9%	-6.2%	31.4%	-24.3%	65.1%
VSTOXX	21.32	48.25	-0.4%	0.7%	10.6%	-17.6%	67.5%
Commodities							
Commodities (CRB)	557.2	n.a.	-0.1%	-2.1%	-3.7%	30.3%	10.5%
Gold (Troy Ounce)	1 791	56.89	0.5%	2.3%	-2.1%	-3.6%	25.1%
Oil (WTI, Barrel)	74.29	40.28	1.5%	-13.2%	-3.5%	58.7%	-20.5%
Oil (Brent, Barrel)	79.81	42.29	3.7%	-14.7%	1.5%	51.4%	-23.0%
Currencies (vs USD)							
USD (Dollar Index)	104.61	39.58	-0.5%	-2.2%	9.3%	6.4%	-6.7%
EUR	1.0606	63.81	0.7%	3.6%	-6.7%	-7.5%	9.7%
JPY	136.14	58.89	1.1%	4.4%	-15.5%	-10.2%	5.1%
GBP	1.2173	55.55	-0.8%	3.0%	-10.0%	-1.0%	3.1%
AUD	0.6705	50.33	-0.6%	1.5%	-7.7%	-5.6%	9.6%
CAD	1.3676	41.66	-0.3%	-1.7%	-7.8%	0.7%	2.1%
CHF	0.9328	60.76	0.4%	2.8%	-2.1%	-3.0%	9.4%
CNY	6.9826	59.31	-0.1%	2.6%	-9.0%	2.7%	6.7%
MXN	19.798	43.10	0.3%	-1.3%	3.7%	-3.0%	-5.0%
EM (Emerging Index)	1 644.8	58.85	-0.3%	1.0%	-5.2%	0.9%	3.3%

Source: Bloomberg, Atlantic Financial Group

Total Return by asset class (Negative \ Positive Performance)



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