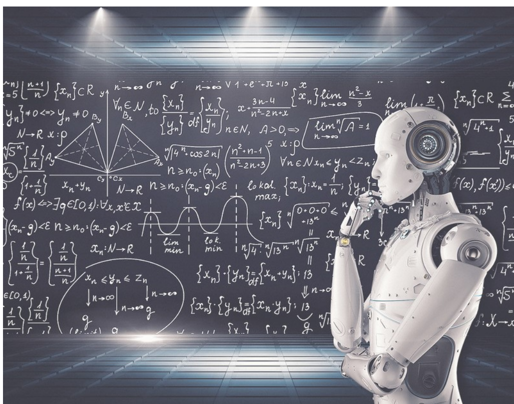
2pm PERSONALIZED PORTFOLIO MANAGEMENT

Quarterly market review

JULY 2023

Editorial

After the stressful banking episode in March and the interminable discussions around the raising of the American debt ceiling, the equity markets started to rise again, carried by the wave of enthusiasm around the theme of Artificial Intelligence, falling inflation figures, a slowing but rather resilient US economy for the moment, and around 500 billion cash in reserve in the hands of American households. The S&P500 rose 8.30% in the second quarter, bringing its rise to +15.91% since the start of the year. But this figure hides huge disparities and perhaps even the beginning of a speculative bubble linked to the emergence of Generative Artificial Intelligence, with ChatGPT in particular. This is how the 7 largest American tech stocks rose 65% from December 31 to the June 15 peak. A company such as NVIDIA, historically specialized in graphics cards, but which has worked extensively in the areas of accelerated computing, AI and metaverse, has even grown by 190% over this period. META, formerly Facebook, has recovered more than 200% since its low point on November 3, 2022. And what about Apple, whose market capitalization alone now exceeds the entire market capitalization of the Russell 2000 index! Never has the performance of the American stock market been so concentrated, on such a narrow number of stocks. It's very simple, if we exclude the 7 mega techs mentioned above, the S&P has only progressed by a modest 3.8% since the beginning of the year! That is to say the number of stocks that have stood still or even fallen in recent months. It is true that the disclosure of ChatGPT to the general public has given rise to the most diverse comments on the degree of impact that this new



generative intelligence will have on our societies. We are devoting our Wide Angle of this July edition to this oh-so exciting topic. Goldman Sachs has just published a study on this subject predicting that AI would improve labor productivity in the United States by 1.5% per year and could give a boost of 400 basis points to corporate margins. These are only speculations, of course, but many believe that the effects of artificial intelligence could manifest themselves more quickly than during previous technological revolutions (electricity, rail, internet, etc.). However, beware of speculative surges as we saw with the internet bubble of 1999/2000.

If there is a bubble in technology, the situation of the real economy could quickly bring investors to their senses. Indeed, advanced indicators such as the inversion of the yield curve, the tightening of credit conditions, the weak manufacturing activity should encourage vigilance and circumspection, although, still in the United States, other still very robust indicators (employment figures, household spending, etc.) continue to militate for a soft landing rather than a serious recession. This is still our central scenario. On the European continent, the other economies are also slowing down and subject to the risk of a monetary policy that could be too restrictive in order to combat the still relatively high core inflation. This is particularly true in the United Kingdom with a BOE which could be tempted to raise its short-term rates above 6% to fight against out-of-control inflation. It must be said that Brexit did not help and contributed to creating staff shortages in certain sectors, in an economy where wages are clearly on the rise. In the Euro Zone, manufacturing activity is marking time and there is a significant drop in bank loans. In China, the post-lockdown rebound is currently disappointing with consumers continuing to be cautious. In short, we are at a point in the economic cycle where we should be careful. And in particular in two aspects: First of all, the quality of the quarterly publications of companies, which proved to be particularly robust in Q4 2022 and Q1 2023. We will know in the very next few days if this is still the case for Q2 2023 and if the level of the margins could be preserved. Secondly, the behavior of the Federal Reserve, whose rapid rise in key rates in recent months has already shown its collateral damage with the stress of March on regional banks. Even more recently, Standard & Poor's reported the highest number of bankruptcies for the first five months of the year since 2010. The latest minutes from the Fed reveal that its members are divided on what to do . Some would like to pause to measure how the restrictive measures of recent months have already affected the

	Q2 2023	YTD 2023	Close 30/06/23
DOW JONES	3.41%	3.80%	34 407.60
S&P 500	8.30%	15.91%	4 450.38
FTSE 100	-1.31%	1.07%	7 531.53
EUROST.50	1.95%	15.96%	4 399.09
CAC 40	1.06%	14.31%	7 400.06
FTSE MIB	4.12%	19.08%	28 230.83
MSCI EM	-0.08%	3.46%	989.48
CRUDE OIL	-6.65%	-11.99%	70.64
GOLD	-2.54%	5.23%	1 919.35
EUR/USD			1.0909
EUR/CHF			0.9769
EUR/GBP			0.8593
EURIBOR 1M			3.399%

economy. Others, like Dallas Fed President Lorie Logan, think more rate hikes are needed immediately to enact meaningful disinflation and quickly bring inflation back toward the central bank's 2% target. An additional rate hike would likely be “bankable” for the U.S. economy. Two rate hikes would certainly increase the risk of recession over the 12-18 month horizon. The observation during the second half of the year of pressure on corporate profits which could encourage the latter to take austerity measures (layoffs, reduction in Capex, etc.) would be a first good indicator of this increased risk of recession. A drop in consumer spending, once their pandemic incentives have been exhausted, would be a second reliable indicator.

As you will have deduced, the markets are therefore at a crossroads at the start of the summer with two opposing scenarios, that of soft landing vs hard landing.

In the first scenario, which is still in our favor in terms of probability, inflation figures continue to fall, thanks to more favorable base effects, the maintenance of energy prices at low levels after the decline of recent months and the absence of a pronounced second-round effect between wages and prices. In this scenario, the US Federal Reserve raises its key rates one last time in July and the ECB gratifies us with two final increases of 25bp, once in July and once in September. Activity continues to deteriorate gradually, without however leading to a large-scale recession and without too much damage to the job market. Long-term rates, after the upward tensions of the past week, are stabilizing and starting to fall again

(continued from page 1) slowly, with the perception in the minds of operators that the process of disinflation is well and truly under way. This decline in long-term rates is supporting equity market valuations.

In the second scenario, inflation remains at high levels, especially core inflation, and central banks decide to extend their restrictive policy. The ECB raises rates in July and September, indicating that there will be further hikes to come. The FED is doing the same and doubt settles in the minds of investors that these additional monetary tightenings could cause a major recession in the course of Year 2024. The equity markets anticipating this type of event 6 to 9 months earlier starts a correction, as well as for raw materials. Real estate is slowing down, the default rate is increasing significantly and volatility is returning to the fore, in stocks as in bonds.

The potential emergence of this second scenario is currently leading us to increase the quality of our bond portfolio, by increasing allocations to Investment Grade and government papers. The High Yield segment can indeed suffer somewhat during periods of recession, through the widening of credit spreads. What's more, the valuations of government bonds now seem attractive to us again and also offer natural protection against growth shocks.

As for the equity part of our portfolios, the watchword is more than ever "DIVERSIFICATION". We believe that the concentration of stock market performance on a very small number of technology stocks cannot last forever and that a healthy sector rotation will eventually take place, a rotation which will allow a good number of today's very late quality stocks to effect a catch-up operation. Geographical diversification as well. It is striking to note that emerging markets have largely underperformed in Europe or the United States since the start of the year (+3.46% for the MSCI Emerging Markets vs. +15.91% for the S&P500 or +15.96% for the Eurostoxx50). And the modesty of the Chinese rebound in the second quarter no doubt has something to do with it. Nevertheless, here too, we anticipate that a geographical rotation will be likely to be put in place to the benefit of these countries, of the same kind as that which propelled Japan this year with an increase of +27.19% since December 31 (we detail the explanatory factors of this increase on page 4 in our Special Topic). We are therefore carefully preserving our positions through our various global and China funds.

Finally, we have identified two exogenous events of a geopolitical nature of low probability for the moment, but for which we have already decided to modify our portfolios at the margin by replacing a few percent of our traditional funds in favor of a mix of highly liquid ETFs, with the aim of putting them in a position to be immediately reactive in the occurrence of one or another major geopolitical shock. These two events are: Use of a tactical nuclear weapon by Russia on European soil (or nuclear accident at the Chernobyl-type nuclear power plant in Zaporizhia) and unexpected invasion of Taiwan by Chinese troops. In the first case, we would certainly witness a stock exchange crash comparable to that of September 11 followed by a rapid recovery, once the amazement and dread have passed. In the second case, more troublesome from a macroeconomic point of view, as the implications are numerous from the point of view of maritime traffic or the semiconductor market, we would most likely see a global recession quickly set in.

Christophe Carrafang

The Big Picture

Artificial Intelligence: The new Industrial Revolution

Humanity has witnessed 3 previous industrial revolutions: first the steam engine, followed by electricity and later computers. Today we are in the midst of a fourth revolution, driven by Artificial Intelligence (AI) and "big data".

AI gives machines – be they computers, robots, drones or otherwise – the ability to "think" and act in ways hitherto unique to humans. This means that these machines are able to interpret the world around them, assimilate and learn through information, make decisions based on what they have learned, and then spring into action, often without human intervention. It is the ability to learn and act on data that is the critical aspect of this "Intelligence Revolution", especially considering the volume of information in the form of computer data affecting us today.

AI needs a lot of data to be able to learn quickly, be accurate in interpreting information and make the most appropriate decision; it is not a new concept but it is now that it is becoming truly transformative thanks to the growing volume of data available in all fields, and to impressive computer advances such as computing power or even distributed information. We are able to accumulate, process and analyze data on an unprecedented scale.

The key difference between all previous technological advances or industrial revolutions and AI or "Machine Learning" is that the former generated increases in physical capacity of what human beings could produce, while the latter will increase the intellectual and mental capacities of human beings. In other words, the impact of all the major technological revolutions has been to push back the quantitative limits of the production of goods and services in a given period. AI is beginning to replicate and surpass the functionality of the human brain. For the first time in history, humans will be in direct competition with computer power driven by algorithms.

AI is a versatile technology that can be applied to almost any field of activity. The implications of the "Intelligence Revolution" will be massive at all levels; all businesses of all shapes and sizes will need to get up to speed. Innovation and change have become normal for any type of industry, and those who fail to leverage AI to improve their own business model will struggle to stay competitive.

The economic impact of this revolution will be major, AI will explode productivity, according to a McKinsey study, Generative Intelligence will make it possible to automate up to 60-70% of the tasks that occupy employees today ! This industrial revolution, unlike the others, does not create new jobs, it replaces them. It's more than an industrial revolution, it's a social revolution.

(continued on page 4)

Macro-economy

<u>Inflation:</u> The decline continues except in the United Kingdom

- **Euro Zone: Further drop in inflation in June to 5.5%, with a “core” index relatively stable for several months at 5.4%.**
- **United States: The price index has been falling for almost a year, it is now 4%, with a "core" index higher at 5.3%.**
- **United Kingdom: Unlike other developed countries, the inflation rate remains high at 8.7%; a consequence of Brexit?**
- **Producer price indices are down sharply almost everywhere, which attests to the manufacturing recession (see below) but is nevertheless good news for corporate margins.**

<u>Labor Market:</u> No strong recession if the labor market holds

- **In developed countries, like Japan, demography will structurally curb the rise in unemployment. Certain factors, such as the reduction in migratory flows to the US, reinforce this trend.**
- **Thus, despite slowing activity, the unemployment rate in the Euro Zone is at its lowest since the start of the calculation of the indicator in 1998, at 6.5%.**
- **In the United States, the unemployment rate rose slightly from 3.4% to 3.7%, but job creations remained solid.**

<u>Manufacturing activity:</u> recession and destocking

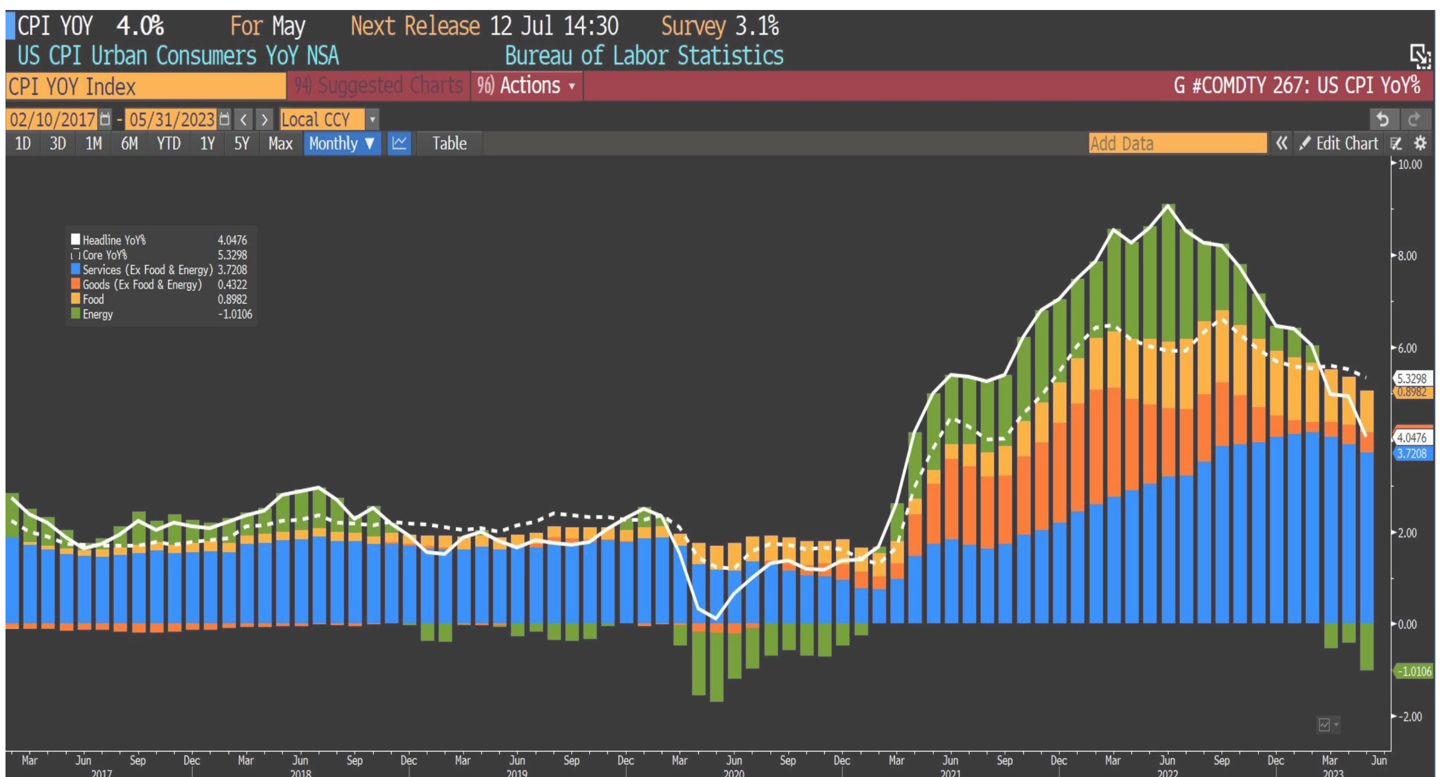
- **The global indicator has been below the 50 threshold for several months.**
- **We are witnessing a probable manufacturing recession in Europe (43.4) and the US (46).**
- **Rising interest rates weigh on investment desires.**
- **The end of destocking could boost activity in the second half.**
- **Only Japan and emerging countries are resisting.**
- **Chinese activity is disappointing especially in terms of exports.**

<u>Services activity:</u> slowdown but no recession in sight for the moment

- **There has been a slowdown in services activity over the past two months in the Euro Zone, particularly for the month of June (52).**
- **This slowdown is less significant in the US, where the indicator, expected just above 50 (51.3), stood at 53.9 in June.**
- **In China, the rebound is substantial even if it is marking time and disappointing observers. Government stimulus actions cannot be ruled out.**

Damien Liegeois

US CPI YoY since 2017



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Special Topic

Japon, the 2023 surprise

A position initiated at 2PM a few months ago, the Japanese market regains its letters of nobility. This performance is not due to chance or to a simple movement of short-term capital. The factors of this success are multiple.

The inflation caused by the reopening of post-Covid economies has done Japanese growth a world of good, mired in deflation for several decades, despite still unfavorable demographics. Wages are rising, service activity is buoyant and, unlike other developed countries, manufacturing activity is expanding.

The fall in the birth rate is a serious challenge that has been taken up head on by the authorities. The country, traditionally very closed, has decided to open up to immigration: At the end of 2022, foreign residents were more than 3 million, a record in this country of 125 million inhabitants.

The new Governor of the Japanese Central Bank (BOJ) will take advantage of this state of grace to modify the ultra-expansionary monetary policy of recent years so that the country finally returns to "normal" interest rates. And even if Mr. Kasuo has promised to do it very gradually, the window for intervention is there.

Beyond these positive elements, the biggest change is to be credited to the market authorities who, in order to increase the attractiveness of the Japanese stock market, have taken decisions in recent years to align the interests of companies with those of their shareholders. They aim to improve governance and value creation in order to come closer to international standards.

Traumatized by the economic crisis of the 1990s, Japanese companies have greatly reduced their debt and practiced a management centered on the income statement, inflating their cash balance sheet. Around 50% of listed companies now have a price to book of less than 1, i.e. no overvaluation compared to book assets. In addition, the balance sheets are full of unpaid cash that has been dormant for far too long, and which must return in one way or another to the shareholders.

To do this, the Tokyo Stock Exchange has just changed the listing rules by requiring companies to implement a growth strategy intended to improve the profitability of their capital. Companies that retain a market value below book value will be demoted from the "prime" index with the obligation to publish the reasons for which they are penalized. In addition, all companies must now communicate their governance policy and improve transparency towards shareholders.

Investors are not mistaken. Warren Buffet has recently increased his investments in several companies in the country. Japan has also become the second favorite market for activists always looking for significant value creation, in an inexpensive market, and moreover not much held in international portfolios.

Damien Liegeois

(Continued from page 2) ***The concrete application best known by the general public at this stage is the OpenAI chatbot, ChatGPT. It represents a real break, not scientific – because it's in the line of technological development – but social and political, via the "gadgetization" of the object, the graphic interface which suggests that we are talking with a human being. The user is therefore inclined to trust him, not questioning what is said. However, you have to remain critical and realize that it is not an instrument that provides sourced knowledge, it works rather by statistics. It therefore gives answers that are always more or less satisfactory but never exact. It is undoubtedly a powerful tool in specific contexts but the consequences can be serious if we assume that it can produce knowledge. There is opacity by construction; there is no transparency as to the databases that have been exploited.***

The risk for society is that by dint of delegating to AI, we lose the ability to think. Above all, let's be aware of the fact that AI is used via platforms that will put users in contact, provide data, through which operators will try to guide behavior, and this from a utilitarian perspective: maximizing the well-being of the group and not that of the individual. The system takes into account the general interest of the community, we are not concerned with the comfort and interest of a single user, which is a major difference from the industrial world, which aims to satisfy the specific customer. It is a societal choice, a universal matrix that tries to smooth everyone's preferences

Much will have to be done in terms of regulation for AI: to start with, the European Union wants to regulate artificial intelligence to guarantee better conditions for its development and use. Already in 2021, the European Commission proposed the first EU regulatory framework for AI. AI systems that can be used in different applications will be analyzed and ranked according to the risk they pose to users. Different levels of risk will involve more or less regulation. Once approved, these rules will constitute the world's first comprehensive IA law.

In summary, whether you are a fan of AI or not, the "Intelligence Revolution" is now with us. Technology is going in one direction, always forward, towards a future that is smarter than ever. We are witnessing transformational changes that will change the technological space for the next 20 to 30 years. Of course, we must consider the implications of AI and work to ensure that it is used in an ethical and honest way that benefits everyone; but in any case, we cannot ignore it!

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