2pm PERSONALIZED PORTFOLIO MANAGEMENT

Quarterly market review

OCTOBER 2022

Editorial

The summer of 2022 has proven to be particularly tricky for investors to grasp and the stock markets have played Russian roulette more than ever, unfortunate pun definitely not intended. The S&P 500 index thus rose from 3,600 points in mid-June to 4,300 points, and on August 16 dropped back down to 3,600 points at the end of September in almost perfect symmetry. Let's try to analyze what happened in order to better understand the coming quarter.

In our previous newsletter at the beginning of July, we highlighted the fact that the markets were beginning to factor in a lot of bad news. We were obviously not the only ones to think so and, despite a still tense geopolitical situation, the month of July as well as the first 15 days of August will have seen a spectacular rebound take place on the American as well as European stock markets, rebound driven overall by good results at corporate level and by inflation figures in the United States, down on previous months and below expectations. This allowed some economists to argue that US core inflation may have peaked and contributed in the first part of the summer to some relaxation among traders regarding expectations of Fed rate hikes. Immediate consequence: falling long-term rates (the yield on 10-year US government bonds fell from 3.50% in mid-June to 2.50% in early August) and a clear stock market rebound (the S&P 500 regaining nearly 18% between mid-June and mid-August!).

Unfortunately, inflationary figures again worried investors from mid-August in Europe and the United States, the dynamism of the American economy even justifying a particularly hawkish speech from Jerome Powell during the symposium at Jackson Hole, August 25-27. The Chairman of the US Federal Reserve has been very clear on the need to continue to tighten monetary policy, noting that there is excessive demand over supply in the US economy, especially on the labor market; specifying that the return to 2% inflation required a better balance between demand and supply, and that the persistence of a restrictive monetary policy would cause difficulties for businesses and households alike. A few days later, at the annual conference of the CATO Institute, he reiterated his Jackson Hole message, stating that the Fed had to act firmly against inflation in order to avoid painful consequences for household prices that would continue to escalate, like in the late 1970s and early 1980s. Powell also discussed what Paul Volcker (Fed Chairman from 1979 to 1987) and the central bank had done to finally get inflation under control after several failed attempts, noting that "the public had come to see higher inflation as the norm and expect it to continue." Such high inflation expectations on the part of consumers maintain the inflationary spiral, making the fight against this price increase even more painful. And the Fed had to, under Paul Volcker, take drastic measures to bring inflation back in line. It is clearly this scenario that the American authorities now want to avoid.

In Europe, this is the harshest scenario that has materialized as far as the ECB is concerned. After having raised its interest rates by 0.5% in July for the first time in ten years, the European Central Bank announced on September 8 a new increase of 0.75%, an unprecedented magnitude. The stated objective is to fight against inflation, which continues to rise in a context of soaring energy prices. The institution now expects inflation of 8.1% for 2022, compared to 6.8% in June. And for 2023 and 2024, the central bank forecasts 5.5% and 2.3% respectively, still well above the 2% target.

These sudden increases in key rates on both sides of the Atlantic and the persistence of high inflation figures (although down slightly compared to June, see the Macro section on page 3), propelled long-term rates to rise. The yield on the 10-year US Treasury thus fell from 2.50% on August 2 to 4% last week, 09/27. Ditto in Europe where the German Bund rose from 0.77% on August 1 to more than 2.20% a few days ago. Difficult with such a brutal rise in rates to have stock markets in a bullish phase. Especially since the Russian rhetoric of recent weeks, which is now addressed to the entire West and no longer to Ukraine alone, contributes to the persistence of a anxiety-provoking climate which is not particularly engaging for operators. Thus, the S&P 500 lost 17% over the last six weeks, bringing its decline to -24.77% since the beginning of the year (figures as of September 30). It is even worse for the Nasdaq index which shows -32.77% over the first 9 months of the year. The Eurostoxx 50, for its part, has fallen by more than 12% since August 16 and has posted a somewhat pleasing -22.80% since the start of the year.

So, what should we expect for the coming quarter? Should we give in to the ambient pessimism and cut risk in portfolios ?

	Q3 2022	YTD 2022	Close 30/09/22
DOW JONES	-6.66%	-21.94%	28 725.51
S&P 500	-5.28%	-25.20%	3 585.62
FTSE 100	-3.84%	-8.15%	6 893.81
EUROST.50	-3.96%	-24.03%	3 318.20
CAC 40	-2.71%	-21.25%	5 762.34
FTSE MIB	-3.03%	-26.13%	20 648.85
MSCI EM	-12.48%	-28.91%	875.79
CRUDE OIL	-24.84%	5.69%	79.49
GOLD	-8.11%	-9.22%	1 660.61
EUR/USD			0.9802
EUR/CHF			0.9674
EUR/GBP			0.8775
EURIBOR 1M			0.679%

We do not think so. As in last July, we are once again observing that a lot of bad news seems to be integrated into current levels. Equity market valuations have literally melted. To take the example of Europe, the Eurostoxx50 was paying less than 10 times the estimated earnings for next year last week, compared to 18 times at the start of 2021. It is even worse for certain sectors such as the automobile which now pays 4.5 times earnings. Or the banks with 6.2 times profits. Moreover, it seems to us that operators are beginning to take stock of the action of central banks in terms of activity. The latest published macroeconomic indicators rather support the thesis of an economy in the process of slowing down, whether it be the drop in the ISM Manufacturing or construction expenditure for the United States or the decline in the figures for production and new orders for Europe. And this is good for long-term rates, which have fallen sharply over the last five sessions, causing the European and American stock markets to rebound violently in the first days of October. The intervention of the Bank of England last week on British long-term rates, following the intervention of the Bank of Japan a few days earlier on the Yen, is also instructive. This signals that central bankers are closely monitoring the economic situation as well as any speculative excesses recently observed (upward on British long-term rates, downward on the pound sterling and the yen). Moreover, that they intend to intervene when certain dangerous levels seem to them to have been reached.

Of course, we will place close attention in the days to come to the next inflation figures that will come out. We believe that equity markets cannot sustainably rebound if inflation figures

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continue to grow and long-term rates continue to rise. Having passed the peak of inflation, especially core inflation, is crucial. We will also be attentive to developments in the situation in Ukraine. The Russian army has suffered setbacks on the ground in recent days, facing a Ukrainian army largely armed by the West and obviously well advised from a tactical point of view. However, the consequence is a rhetoric by the Russian authorities which is becoming more radical. Vladimir Putin has stepped up a notch in his threat and his chief officers no longer hesitate to speak in a completely uninhibited way about the use of tactical nuclear weapons. Is this just a scare tactic? Bluffing to get Westerners to negotiate? Or should this threat be taken very seriously? Experts on all sides are far from agreeing on this point. What will Putin do if he feels cornered in Donbass or if Ukraine has an insurge of spirit, on the strength of its recent breakthroughs, to go and recover Crimea? Be that as it may, it is obvious that the use of a nuclear missile, even "light", would not be good news for the markets in the short term, as the psychological shock would be significant. Finally, we will be focused on what is happening in China (see our Special Topic on page 4). The world's second power hasn't helped global growth much lately and Chinese stocks have remained under pressure since the year began. But we are perhaps at a turning point with the 20th Congress of the Chinese Communist Party which is taking place and which could lead the country towards more pragmatism in many areas.

We are delighted to note that in the face of the energy crisis and the surge in gas and electricity prices compared to last year, many European countries have taken support measures, setting up price shields in order to mitigate the impact of this crisis on households. To date, close to 400 billion euros have been mobilized in this effort and other packages could be put in place before winter. In the longer term, the energy transition and the transformation of our economies towards low-carbon production continue to benefit from very strong support. With the signing of the Inflation Reduction Act (IRA), the United States has committed enormous resources to clean energy and this could be a secular opportunity in terms of investment, since growth expected is significant in this sector for many years to come. Same goes for the world of infrastructure, which benefits from massive investments in Europe and the United States.

In the weeks to come and in this still uncertain context, we will remain faithful to our philosophy which consists in not making too violent a slash in allocations, in adopting a long-term vision, while being ready, when the time comes, to add a bit of risk to portfolios. It is worth recalling here that each period of history has generated challenges and shocks that seemed insurmountable at the time. These events, widely debated in the press at the time with anxiety-provoking headlines, nevertheless had little significance in the end for the financial health of companies and are, for the most part, long forgotten, be it the Gulf War, the Asian crisis of 1997, 9/11 or the Lehman Brothers bankruptcy, to name but a few. What the history of financial markets over the past fifty years teaches us is that investors who have been willing to look beyond short-term shocks have been amply rewarded afterwards. It is even notable that sophisticated investors have most often obtained their best results by placing their assets in times of great uncertainty, at the height of bad macro-economic news and at 2PM, we strive to adopt this attitude which is both contrarian and counter-intuitive, not forgetting that in most cases, bull markets are born in times of recession and extreme pessimism.

Christophe Carrafang

The Big Picture

United States, Europe: similar symptoms for a different crisis…

Both the United States and the Eurozone are facing a crisis situation. The symptoms are the same: inflation and economic slowdown. But the crisis that the United States is going through is different from that of Europe. In particular, the causes of the crisis: the United States is facing a demand shock, and Europe, a supply shock.

> In the United States, economic overheating began at the end of the Covid period, boosted by government aid sent to Americans. Excessive demand that led to shortages and bottlenecks causing prices to soar. A tight labor market, where companies are struggling to hire, forcing them to raise wages. Finally, a real estate market at record prices.

> In Europe, there are also government post-Covid recovery plans to help populations, supporting strong demand. But what is particularly slowing down the European economy is the energy crisis triggered by soaring gas prices. It started in the fall of 2021 with shortages and export cuts from Russia, before escalating last February with the war in Ukraine.

To respond to this, central banks have had to focus on modifying their monetary policy, but with a different timing and magnitude:

>In March 2022, the Fed started its rate hike process which continues today. With, however, a delay in starting up, because US "core" inflation (excluding food and energy prices) was already 6.5% at the time (as a reminder, the Fed has a target of 2 % core inflation). Today, the Fed no longer hesitates and is determined at all costs to curb inflation. Faced with the overheating of the American economy, it is doing everything to slow inflation by raising interest rates and withdrawing liquidity. Rising rates have a direct impact on the cost of borrowing for businesses and consumers. Real estate represents an important variable in the calculation of inflation. The price of housing and rents have increased by more than 30% in recent years. For the past two months, prices have stabilized and are even beginning to fall, following the surge in mortgage rates to 30Y: they have gone from 3.11% (at the start of the year) to 6.29% recently. Tensions on the labor market must disappear because they fuel wage inflation. The job market is tight: if we look at the number of vacancies compared to the number of unemployed, there are twice as many vacancies as unemployed. The Fed needs to slow the economy to relax the labor market. Consumption is not weakening: since Americans are not worried about their jobs, they continue to consume using the savings accumulated during the Covid crisis, which allows them to absorb the inflationary shock.

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Macro-economy

Inflation, again and again...

United States:

- Inflation has fallen over the last two months to +8.3% against +9.1% in June.
- However, excluding cyclical effects, prices rose between July and August from +5.9% to +6.3%, with a peak in March of +6.5%.
- Some prices are starting to fall, especially those linked to supply disruptions which are gradually easing.
- With the rise in interest rates on loans, the real estate sector is starting to show signs of weakness.
- The labor market remains dynamic; the unemployment rate rose slightly from 3.5% to 3.7%.
- In comparison with the strong growth of 2021 (+5.7%), the evolutions of the GDP of the first two quarters are negative respectively at -1.6% and -0.6%.

Eurozone:

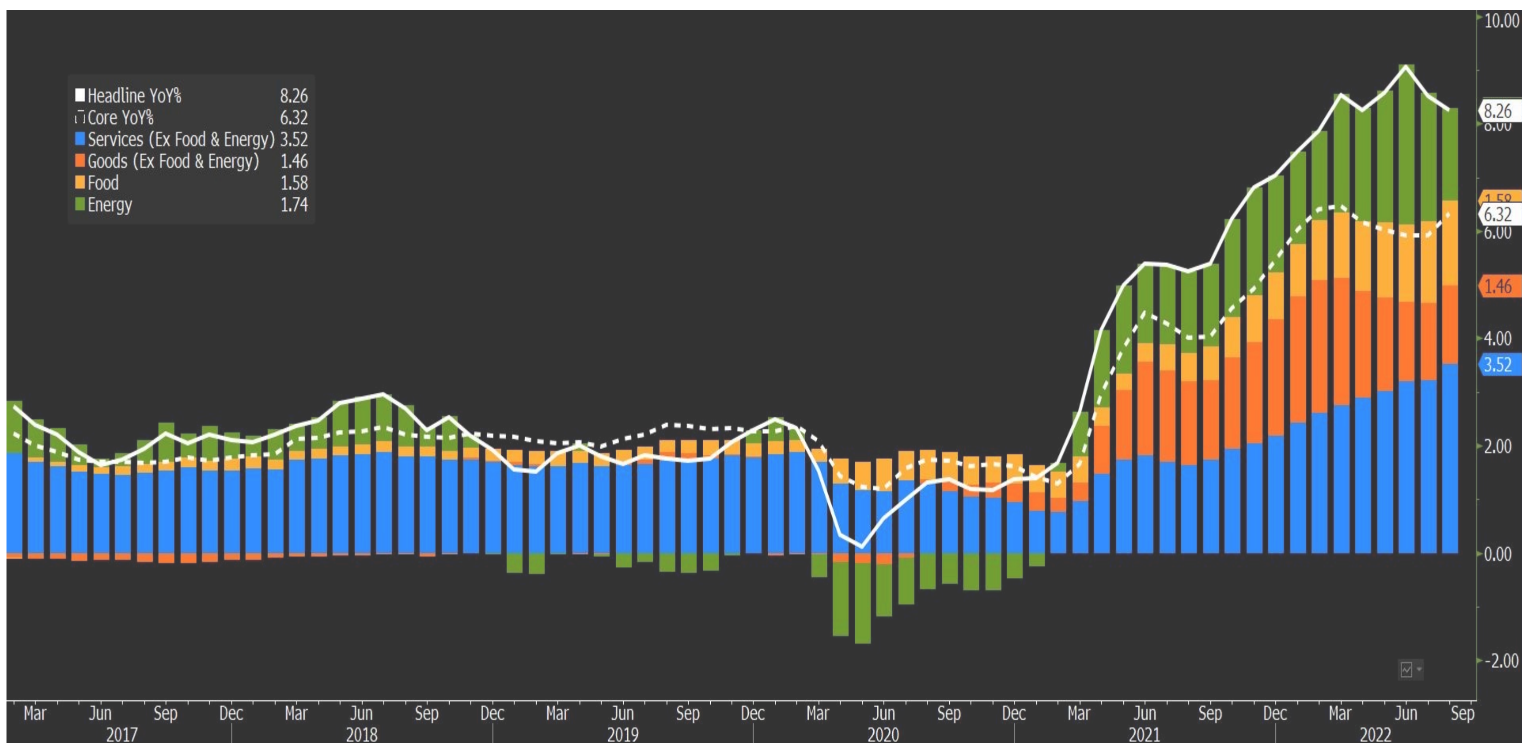
- The impact of the energy crisis in Europe is responsible for more than half of the price increase.
- Inflation reached +10% in September, excluding energy “only” +4.8%. With big gaps: +6.2% in France, +10.9% in Germany.
- Manufacturing and services activities have been slowing for several months. The geopolitical crisis and the sanctions against Russia affect the continent and particularly those countries most dependent on Russian energy.
- Over the first part of the year, the evolution of GDP is positive but rather anemic. In the second quarter, growth was +0.8%; +0.1% for Germany and +0.5% for France.

China:

- The Chinese macroeconomic environment is different with an expansionary monetary policy.
- With the difficulties of the real estate market and the stop and go of Covid restrictions, inflation remains strongly contained; it even fell this summer from +2.7% to +2.5%.
- After peaking above 6% in the spring, the unemployment rate fell to 5.3%. Youth unemployment remains high and close to 20%.
- The Communist Party Congress in October should bring new stimulus measures.
- In the second quarter, growth was close to zero. Economists estimate that it could gradually rise towards 5% by the end of the year.

Damien Liegeois

US CPI YoY Index (*) since 2017



(*) This Consumer Price Index represents changes in prices of all goods and services purchased for consumption by urban households.

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Special Topic

20th Chinese Communist Party Congress: What can we expect?

On October 16, the 20th congress of the PCC will open, bringing together 2296 delegates (including 619 women). Every five years, this congress defines the main political and economic orientations of China for the next five years. This will be the third congress headed by Xi Jinping. The former had paved the way for an intense anti-corruption campaign that enabled Xi to sideline his main rivals. The second was above all the scene of the drastic and sudden implementation of numerous reforms and regulations that affected the sectors of education, real estate, the Internet, online games... all in a context of strict policy of fighting against internal opposition: Hong Kong, Xinjiang, Tibet. What will be the nature of the congress which will open in mid-October? All observers are betting (and hoping) for a more pragmatic than dogmatic approach on a good number of subjects, with the aim of achieving the long-term objective dear to the Chinese President, namely “common prosperity”.

Various aspects will need to be examined:

At the **domestic political level**, it is to be expected that Xi will not respect the tradition of the maximum two terms for the post of President of the Republic and head for a third term. There will also be the replacement of Prime Minister Li Keqiang, as well as some members of the Politbureau. The name and pedigree of the management team will be carefully observed, and could also be decisive in the conduct of **foreign policy**.

On this subject, the messages will be important on a possible warming of the Sino-American relationship (which has started timidly for a few months). In this same respect, it would seem that the relationship with Russia has gone from the “limitless friendship” of March to a less intense relationship, particularly since the stalemate in the Ukrainian conflict. For China, Russia is not "an ally" but "a partner", which is an important nuance. The very sensitive subject of Taiwan will also be a red thread of foreign policy, even if China repeats over and over again that this is a purely internal issue, where the long-term objective will not change.

Finally, and probably the most awaited, will be the **economic announcements**. The current sharp slowdown linked to the difficulties of the real estate sector and Covid restrictions has paradoxically turned out well for the global economy. Indeed, inflationary and monetary policy pressures would have been much worse if the Chinese economy had been in full “boom” which would have caused additional pressure on the price of raw materials.

But as we witness an economic slowdown in Europe and the US, and that the peak of inflationary pressures may be behind us, Chinese stimulus measures for 2023 will be welcomed. Since the beginning of the year, the authorities have already implemented support policies, but the stop and go due to health restrictions throughout the year have rendered these measures ineffective. We, therefore, expect jointly three types of decisions: a relaxation of Covid restrictions, targeted and strong announcements in order to revive the real estate sector (25% of GDP, 50% of household wealth), and measures to lower the youth unemployment rate which has risen to 20%.

Three very sensitive subjects for public opinion, who are lacking in confidence after two difficult years.

Let's hope that these announcements will also restore confidence in Chinese financial markets, which have been particularly neglected by investors since the beginning of last year.

Damien Liegeois

Xi Jinping, picture under licence Creative Commons/ attribution: www.kremlin.ru

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> In Europe, the situation is not as clear. This is why the ECB is reluctant to undertake a process of raising rates as aggressively as in the United States. A rate hike would have an impact on demand, but none on the energy supply problem and looming gas prices. And the contribution of the energy component to inflation is not the least: it represents almost 50%. At present, it is difficult to visualize the resolution of the conflict. For this winter, countries have adapted; found alternatives to Russian gas, and stocks are filled to sufficient levels. What about next winter? The situation may also become delicate for Russia's finances: it could find itself unable to recycle its gas due to reduced storage capacity. “The fate of Europe” depends on European politics rather than central banks. From a stock market point of view, the divergence between American and European monetary policies is not reflected in the performance of equity indexes: the S&P 500 fell by -24.8% and at 30/09/2022, the EuroStoxx 50 fell by -22.8% this year. On the other hand, when looking at the currency market, investors have clearly chosen their side. As of September 30, the USD appreciated by +16% against the euro. This is positive for portfolios, because we have a weighting of USD which fluctuates between 15 to 25%.

Damien Beasse

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