Prime Partners

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MARKET INSIGHT

DECEMBER 2022

CITYWIRE SWITZERLAND TOP50 INDEPENDENT ASSET MANAGERS 2022

Market Analysis

December 2022

Global economic turmoil and the challenge of optimal resource allocation

Main goal of economy unchanged

The challenge facing any economy can be summarised as the need to achieve optimisation in the face of constraints, i.e. to maximise output given available resources.

This goal is always the same, regardless of the model chosen (market forces, planning, etc.). However, the context in which this process takes place can vary significantly.

During the COVID-19 crisis, there was talk of changes to the general environment that would frame the future of the world economy. The unexpected, or at least poorly understood, return of high (and potentially long-lasting) inflation is, in this respect, a clear legacy of the health crisis.

Conditions changed significantly in 2022

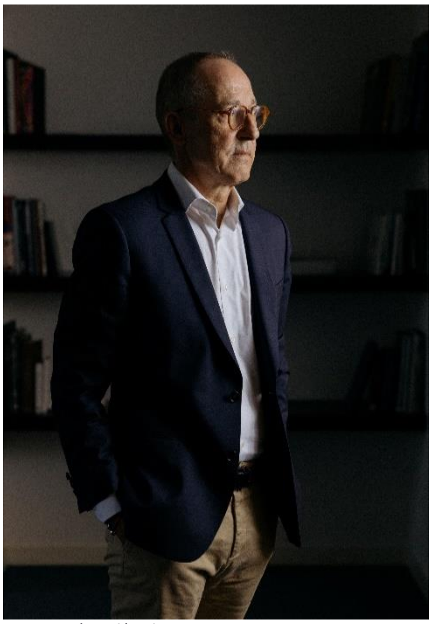
The issue of inflation, already present at the start of 2022, has continued to impact economic and financial developments over the past 12 months.

This new environment required an adjustment, following decades of disinflation, or even the risk of deflation, as in Japan or Switzerland.

The monetary reaction to this new reality was too slow, which helped make 2022 one of the worst years for financial markets in over five decades.

The bear markets in both bonds and equities stem from the "new state of play" on inflation, which has destabilised investors.

Blaming the world's leading central banks is now standard practice. Without denying their share of responsibility, we should recognise that they are not entirely at fault.



Due to Russia's invasion of Ukraine, 2022 will be remembered as a major turning point for the world economy. However, other factors were also at play, such as the continued deterioration in Sino-American relations (Taiwan, US restrictions on semiconductor exports) and the clear failure of the Chinese health authorities to bring COVID-19 under control.

Rapid and combined multiplication of crises

The direct or indirect consequences of these events have marked the last few quarters and their impact is almost certainly far from over. This has in turn fed sentiment of a shifting environment and/or a generally more uncertain world.

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Today the energy, food, environmental and international relations crises are referred to almost daily.

The repercussions of these crises are no less debated: the end of the peace dividend, increased regionalisation at the expense of globalisation, the State's renewed role as economic strategist, or increased calls to speed up progress in the (increasingly essential) energy transition.

Of course, some of these trends were already underway, but 2022 has seen a clear acceleration. With this convergence of "shock waves", many understandably feel that the world is facing a "perfect storm".

We spoke above about the importance of context when economies seek to achieve optimisation in the face of constraints. Undoubtedly, 2022 has strongly tested this idea.

2022 has created long-term challenges of a very different magnitude than those resulting from the crisis of 2020

Pessimists emphasise the insurmountable nature of these developments, as well as their profound and long-lasting impact. By contrast, optimists point out how the system has quickly adapted, as seen with the Fed's very swift monetary tightening from the spring onwards and Europe's measures to tackle the energy crisis. In other words, the system has without breaking.

We remain convinced that 2022 cannot be compared to 2020. The health crisis fuelled – at times excessive – talk of a fundamental change to the economic environment, to which economies would have to adapt.

The bursting of the tech stock bubble in 2022 (especially for the less profitable among them) confirmed that assumptions about a structural change in the environment in the wake of COVID-19 were far from all true.

Conversely, the turmoil in 2022 has led to lasting adjustments that will be difficult to reverse.

For example, will Europe ever go back to being dependent on Russian hydrocarbons? Given the measures adopted in recent months, reinforced by the new agreement between Qatar and Germany on the supply of LNG over the next 15 years, this seems unlikely.

Are Sino-American relations improving, as seen with the recent meeting between Xi Jinping and Joe Biden at the G20 summit? It is tempting to point out that a détente was possible in the second half of the 20th century, even in the context of the Cold War.

Can the war in Ukraine end in a compromise peace? The diplomatic route is clearly desirable, but there is nothing inevitable about it, at least in the short term. Europe can only try to manage the consequences, with the entry of Sweden and Finland into NATO being just one example of this.

An even greater challenge when it comes to investment decisions

These issues have fed into our line of thought, and continue to do so. Navigating the waters of this new global economic environment has not been easy.

We have made mistakes in implementing our investment policy over the last few quarters.

However, we have tried our best to avoid the many obstacles that have arisen, and have sought to keep you fully informed of our views and of any adjustments to our investment policy.

We wish to thank you for your patience and trust during this turbulent year, which has tested our nerves to the limit.

Looking to the future

With 2023 fast approaching, the general context is clearly full of uncertainty.

The issue of inflation has dominated 2022, and should continue into the coming year, even if we expect a more favourable outcome. In this respect, the fight by the main central banks is starting to bear fruit, especially in the US.

We still expect prices to decelerate further, with a return to inflation at more reasonable levels (around 5%) by the end of the first half of 2023 a possibility in the US.

It is therefore clear that monetary tightening aimed at reducing demand in the major developed economies will weigh on the global environment. The economic downturn will thus continue, at least in the first half of 2023.

To reiterate, the probability of a global economic recession stands at 50% and the most likely alternative is weak and erratic growth (25%).

Debates about the nature of a possible recession have been ongoing for months. Given the continued strength of labour markets and the likely end of US monetary tightening by spring (we expect 75-100 bps of rate hikes from current levels), we anticipate a limited contraction in the event of a recession.

Defensive investment focus

Our allocations have changed significantly since January, with their focus reinforced over the last quarter.

We entered 2022 strongly underweight on bonds and slightly overweight on equities, but reversed this trend over the year, with the summer rally in equities leading us to scale down to relatively more favourable levels when compared with the spring.

As 2023 approaches, we hold a strong position in cash and bonds. In this respect, we increased the weight of bonds in November, as announced in our last Market Insight. We have once again chosen the most defensive segments (the safest government and corporate debt).

Given our views on the economy and US monetary policy, the risk premium on these fixed-income assets is attractive. It should be noted that the rally in bonds since mid-October should encourage more restraint in extending duration in the short term.

This does not negate our desire to increase duration over the longer term, but we recommend waiting for better opportunities. A return to 10-year US Treasury yields in the range of 4.10%-4.20% may be the right time to act.

As you can see, general conditions should discourage excessive risk-taking in a diversified portfolio, at least initially.

The bond weighting is likely to be increased further, if not in the next few weeks, then in the coming months. However, it is still too early to reconsider our cautious message on the high-yield segment over the medium term.

As we approach 2023, we are underweight on equities and our sector positioning on the stock markets is relatively defensive, for several reasons.

Firstly, we feel the market rally since mid-October has been excessive and will lead to a correction.

Secondly, in recent months we have reached the upper limit of our fluctuation bands (e.g. 3600-4100 on the S&P 500), which constitutes an important short-term technical hurdle.

Thirdly, following the rally of the last few weeks, market valuations are no longer so attractive, given the increase in multiples.

Last but not least, earnings growth for 2023 remains highly uncertain. This lack of visibility should prompt caution, at least in the short term.

The first quarter will remain turbulent for the stock markets, with limited potential for the indices over the next 12 months. A target of 4100 for the S&P 500 by the end of 2023 seems reasonable.

Given recent levels, there is clearly no reason to rush into stocks in the short term.

Reducing inflation will remain critical for the stock markets in 2023. The sooner and more sharply inflation falls, the sooner traders can put earnings back under the spotlight and refine their outlook.

If the "recession" is contained, the markets should be able to stabilise within a broad fluctuation band in the short term, before returning to the upside. In other words, a new low on the indices (e.g. 3200 on the S&P 500) in the current bear market will be all the more unlikely, since the Fed will be able to halt monetary tightening by the beginning of the spring, limiting the economic downturn.

This scenario is not inconceivable, and we should be ready to seize any opportunities that arise, by increasing the weighting of equities and modifying our current defensive sectoral position.

Despite more favourable recent developments, our currency positioning has been a source of frustration in 2022, due to the continued strength of the US dollar in particular.

We remain convinced that the greenback is overvalued, and that the next few quarters will see it decline as rate hikes in the US come to an end and the economy slows down. In addition, the Democrats' better-than-expected showing in the US mid-terms significantly limits the chances of fiscal or budgetary stimulus measures being adopted across the pond.

We are raising our EUR/USD range to 1.00-1.04 in the short term, while maintaining a target above 1.05 for the end of 2023.

As for the Swiss franc, after a sharp rise following the SNB's monetary tightening in June, the currency has fallen back slightly against the euro in recent weeks.

We expect the Swiss franc to remain strong in 2023, due to better control of inflation in Switzerland compared with the rest of the world and the prevailing global uncertainties. Sideways trading between 0.95 and 1.00 against the euro should be expected in the coming quarters.

Our investments in gold have recently been the source of some pleasant surprises, following several months of disappointing performances. This was mainly due to the weakness of the dollar and the easing of real interest rates. We remain upbeat about gold over the medium

term (12-month target of 1950), even if its recent gains are eaten away in the immediate future.

We have exposure to the energy segment of commodities through our equity positions.

Lastly, in the context of our central economic scenario, we advise against exposure to industrial metals, except for certain metals essential to the energy transition and electrification (e.g. copper).

In conclusion, like so many others, we are happy to see 2022 come to an end, particularly for the financial markets.

However, the turbulence seen in 2022 won't end on 31 December – far from it.

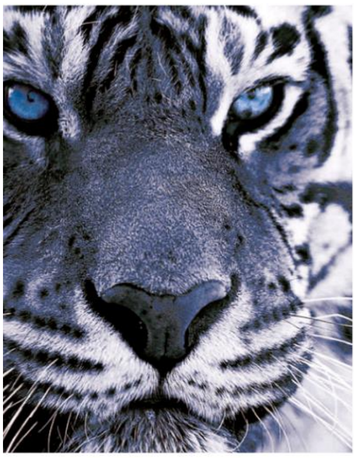
Risk is always an opportunity waiting to be seized, but this is not the time for indiscriminate risk-taking.

We are entering 2023 with a defensive bias, which is reflected in our convictions (e.g. on the dollar and gold) and in the desire to continue the work begun on strengthening our bond portfolio.

This does not seem like the right time to adjust our underweight on equities. We will review this on an ongoing basis, but take for granted that the first quarter of 2023 will remain challenging for this asset class.

We would like to take this opportunity to wish you a happy holiday season and all the best.

Geneva, 30 November 2022



Prime Partners SA
Rue des Alpes 15
P.O. Box 1987
1211 Geneva 1

www.prime-partners.com

CONTACTS

François Savary
Chief Investment Officer

Jérome Schupp
Equity Analyst

Julien Serbit
Senior Investment Advisor

Tel +41 22 595 09 97
fsavary@prime-partners.com
jserbit@prime-partners.com