Capicura Partners – Outlook 3rd Quarter 2022

June 21, 2022

70s or 90s?

- ***Financial markets sell off – rising probability of a recession***
- ***Will the Federal Reserve manage a "soft landing" like in 1994 or is a "Volcker moment" looming?***
- ***Base effect should lead to lower inflation figures in the second half – inflation remains elevated***
- ***Poor visibility persists – risk for further 10 - 15% equity market correction***
- ***Investor sentiment at historic lows opens the door for short term technical recovery***
- ***Stick to strategic asset allocation***

The current financial market environment is extremely challenging, as many problems remain unresolved and are partly interdependent. High inflation rates, rising commodity prices (energy as well as food), interrupted supply chains, rising interest rates, the ongoing war in Ukraine, Covid19 zero tolerance strategy in China etc. clearly reduce short term visibility. The probability of a recession has materially risen in recent weeks. The market fears that the high inflation (8.6% USA, 8.1% Eurozone) can only be brought under control by inducing a recession - analogous to the late 70s / early 80s, when the then Federal Reserve (FED) Chairman Paul Volcker triggered a recession by aggressively raising interest rates, thereby winning the fight against inflation. The exit from ultra-loose monetary policy "hurts" and means headwinds for "liquidity-spoiled" financial markets (for both nominal and real assets). As a positive side effect, negative interest rates in the Eurozone will soon be a thing of the past as the European Central Bank (ECB) will raise rates above zero later this year (25bp in July, 50bp in September). The Swiss National Bank (SNB) surprised most market participants with its bold 50bp move last week and demonstrated its independence. This means that as early as September this year, the SNB's almost 8-year negative interest rate regime will (finally) end.

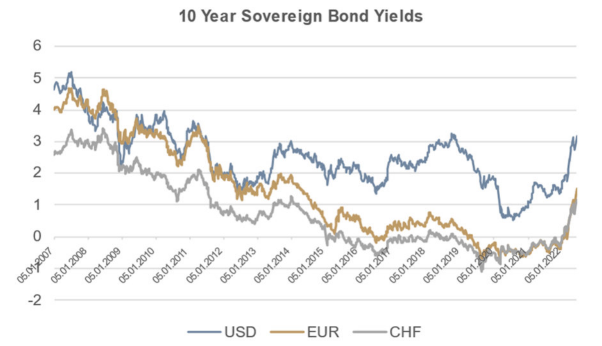

Fig. 1) 10-year Sovereign Bond Yields */Data Bloomberg, Chart Capicura Partners AG*

«A recession is only about 60% factored into the prices»

Most stock markets are clearly in the red since the beginning of the year e.g., -17% Swiss Performance Index, -22% MSCI World and -29% Nasdaq100 (in local currencies). From their respective highs, the results look even worse. In historical comparison and based on different analyses, stock markets (S&P500) on average lose about one third of their value ahead of a recession. Such a correction typically lasted about a year. Given the strong corrections in the first half of 2022, we assume that about 60% of a recession is already priced into the market.

«If recession probability continues to rise, S&P500 likely to correct to 3'200»

Should the recession probability continue to rise, there is additional correction potential for the S&P500 into the region of 3'200 – 3'500 points or a further 10 - 15% downside from current levels. This should reduce the forward P/E ratios of the S&P500 from currently around 15 times to 13.5 times. Valuations of European equity markets are more attractive with an expected 2023 P/E ratio of 10x. Anticipating a recession is difficult or near to impossible. The shape of the yield curve is often used as an indicator but is not painting a clear picture. Stock markets are also a poor forecasting tool. Economist and Nobel prize winner Paul Samuelson recognized this early on, saying, "The

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stock market has predicted nine of the last five recessions." A "soft landing" is the declared goal of the U.S. FED, an endeavor that has so far succeeded only once, back in 1994. Back then, the Fed raised key interest rates by 300bp within 12 months without maneuvering the economy into a recession. Only time will tell whether this plan will work again. The financial markets still need to get used to the changing central bank policy (rising interest rates & quantitative tightening "QT"). The strong monetary tailwinds that have persisted since the financial crisis have turned into headwind. This will lead to higher volatility on financial markets and pose additional challenges for investors.

«Soft Landing or mild recession most likely scenario»

We see the following three scenarios:

Scenario No. 1: U.S. Federal Reserve succeeds in cooling economic activity (soft landing) or cause a mild recession. The base effect calms inflation and inflation expectations therefore gradually move toward central bank targets. Interest rates do not rise further, and the FED can shift to a more "Dovish" rhetoric. Yields at the longer end of the curve decrease, equity markets see a "rebound" and volatility calms down. We see the **probability** of this scenario at around **60%**

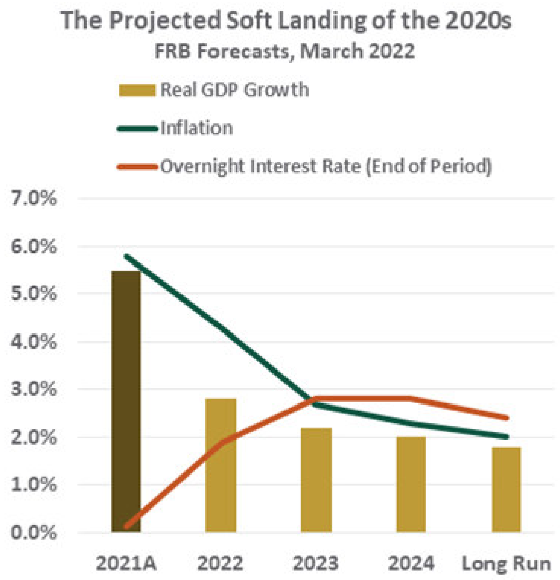

Fig. 2) *Source Northern Trust / Bloomberg, Federal Reserve.*

Scenario No. 2: 1970-Like scenario, inflation continues to rise; central banks raise interest rates more than anticipated and trigger a deeper recession ("hard landing"). This leads to an inverted yield curve; stock markets correct further, and commodity prices (incl. energy) also weaken. We rate this scenario with a **35% probability**

Scenario No. 3: Return to an above-average growth path, **probability 5%**

«Summer months until October remain challenging and volatile»

How should investors position themselves? There is much evidence to suggest that the summer months will remain challenging and volatile well into autumn, and that investors will need a strong set of nerves. However, it is difficult to nearly impossible to "time the bottom" and take advantage of the volatility. Given the "disastrous" investor sentiment, a strong, technical rebound can also occur any time. Keeping a cool head should pay off in the long run.

Experience tells us that only a few investors manage to take advantage of potential setbacks and have the courage to re-enter markets at lower levels. It is therefore advisable to stick to the defined strategic asset allocation. What is worthwhile, however, is to diversify the portfolio and, if necessary, to position it somewhat more defensively. We will not (yet) rebalance our portfolios until there is a bit more visibility from the economy and the earnings side. However, given the elevated inflation rates, we remain convinced that real assets should continue to be favoured and cash can only be a temporary store of value. However, it must be stated that there are currently very good opportunities for investors to build up a new portfolio in both equities and fixed income (credits).

Asset Allocation	
Cash	*10%*
Fixed Income	*15%*
Equities	*50%*
Alternative Investments	*25%*

Fig. 3) *Suggested asset allocation for a Balanced Portfolio in Q3 2022*