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Capicura Partners – Outlook 4th Quarter 2022

September 30, 2022

Central Bank induced economic slowdown – caution warranted

- ***Imbalance of supply and demand can only be met by destroying demand***
- ***Central Banks continue to raise interest rates with no mercy. Bond yields become attractive again***
- ***Very high probability of an European recession – increased probability in the US***
- ***Volatility in currency markets reflects different or even opposite moves in fiscal and central bank policies***
- ***Investor sentiment as bad as in June – capitulation move pending?***
- ***Hold on to adjusted allocation from end of August, reduce risk into a possible recovery***

Investors' concerns have remained unchanged since our June Outlook. During the summer months, the markets even posted a noticeable recovery based on hopes that inflation would weaken and that the US Federal Reserve interest rate pivot level would be reached in H1 2023. However, the central bankers' meeting in Jackson Hole at the end of August abruptly dashed those hopes. The short but clear speech by Fed Chairman Powell prompted us to reduce equity risk in the mandates on August 29 (see update). Interest rates have continued to rise after various central bank meetings (SNB, FED, ECB, etc.) last week and are weighing heavily on equity markets which are now trading around their June lows again. The correlations of almost all asset classes have risen towards 1, indicating the stress in the system and showing that there is currently no place to hide other than in cash (see fig. 1). In the short term, "Cash is King" despite high inflation rates and corresponding negative real interest rates. Even listed real estate investments have corrected strongly, which will probably also have an impact on the non-listed sector, even if this is not yet noticeable.

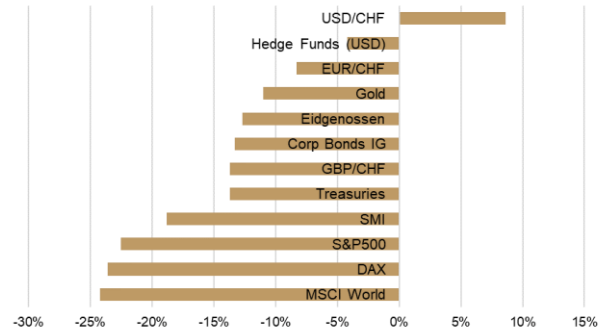

***Fig. 1)** Performance major indices YTD as per 27.09.2022*
Data Bloomberg, Chart Capicura Partners

«Imbalance of supply and demand can only be met by destroying demand»

Fighting inflation takes precedence over economic activity, thus accepting or even provoking a recession. Post pandemic, supply and demand are in a clear imbalance. Normally, the supply side would increase in the direction of demand but because this is not possible due to various factors (supply chain problems, labor shortage, covid restrictions in China, war in Ukraine, etc.), the high inflation can only be countered by "destroying" demand. This is now being done by major central banks and even confirmed by ECB President Lagarde in a recent interview. This means further rising interest rates or with other words, rising recession risk (very high probability in Europe, increased probability in the USA). In Europe, with an expected P/E ratio of 9.7x for 2023, a lot should already be priced in. In a recent Bank of America fund managers' survey, the odds for a recession Europe were put at 92%.

«The market expects S&P500 earnings to grow 8.1% in 2023»

In the U.S., the market expects +8.1% earnings growth in 2023, with revenues expected to rise 4.5%.

These are growth figures which are difficult to achieve with the increased likelihood of a recession and rising input costs. Analysts are likely to cut their estimates starting mid-October when companies report their 3rd quarter numbers and give guidance for the last quarter of this year. A correction in the S&P500 towards 3'200 is therefore still possible (adjustment of the P/E ratio to approx. 13x).

Fig. 2) *Expected S&P500 Earnings-Growth 2023 Data FactSet / Chart Capicura Partners*

Another area of increased volatility is the currency market. It is not only an indicator of interest rate differentials between the various currency blocs, but also of the fiscal policies of the various governments. The US dollar remains a safe haven in times of uncertainty, as does the CHF. The new UK government's mini-budget and the sharp correction in GBP has shown how additional government debt can strain investor confidence and undermine central bank efforts. The current debates on taxing excess profits increases the risk of rewarding losers and punishing winners. Such “moral hazard” is bad for risky assets in general and for equities in particular (higher risk premium needed). China's economy also continues to weaken, which can be explained by the dire situation in the real estate market, the zero-covid strategy and the upcoming party congress on October 16.

«Bonds offer attractive returns again»

What was recently referred to by the acronym "TINA" (there is no alternative), and which mainly spoke in favour of equities, has now received valid competition. Currently, only just under 5% of all outstanding bonds are trading at negative yields. At its peak in August 2019, this figure was 30% (see fig. 3). Cash is no longer being charged with negative interest rates (EUR/CHF) but rather yielding a return (USD/GBP) and some bonds are offering attractive yields (2-year US government bonds yield over 4%). The yields are even higher if one is willing to bear credit risk as "spreads" have widened further. If one expects a prolonged recession in the US, it is even advisable to buy government bonds with longer dated maturities (higher interest rate sensitivity). A recession will have a negative impact on the labour market and dampen inflation expectations. It would then be possible for the FED to gradually lower interest rates again.

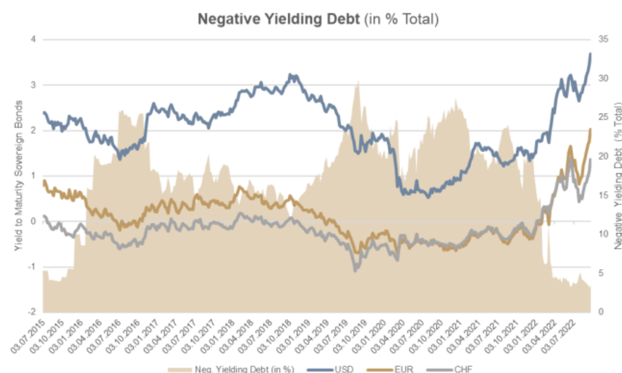

Fig. 3) *Development of negative yielding bonds and sovereign bond yields, Data Bloomberg / Chart Capicura Partners*

«A potential recovery should be used to reduce risk further»

The high correlations mentioned above, the volatility index (VIX) above 30 and the extremely poor investor sentiment (cash levels of fund managers have not been this high since September 2001!) suggest from a "contrarian" point of view that a technical recovery in the markets could be imminent. This is the reason why, at current levels, we are sticking to the adjusted positioning from end of August. We plan to take advantage of a potential rally to further reduce risk. What could be a trigger? Lower inflation numbers, falling energy prices, weaker US labour market or an improvement in Ukraine.

Asset Allocation	
Cash	15%
Fixed Income	15%
Equities	45%
Alternative Investments	25%

Fig. 4) *Suggested asset allocation for a Balanced Portfolio in Q4 2022*

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