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Capicura Partners – Outlook 1st Quarter 2023

December 20, 2022

Limited Visibility – adjusted speed warranted

- ***4D – Inflation and Interest Rates higher for longer***
- ***Markets too optimistic on US interest rate cuts in H2 2023***
- ***Global recession realistic in 2023 - stagflation a possible scenario***
- ***US dollar with further setback potential***
- ***US corporate earnings in 2023 with room for disappointment***
- ***Hold on to cautious asset allocation***

A bad year in many respects is coming to an end. Instead of listing all the negatives, we prefer to look ahead. Although we expect the environment to remain challenging for the next three to six months, we are optimistic that 2023 will be a transition year, providing good opportunities to position ourselves for an interesting and better second half in 2023.

«4D – Demographics, Deglobalisation, Decarbonisation, Debt Levels»

US inflation is falling markedly due to aggressive central bank policy, improved supply chains and ultimately also on base effects. This is a good sign, but market participants might be too optimistic about how quickly the US FED will start cutting interest rates again. The market assumes that the US FED fund rates will be reduced as early as mid-2023. We expect inflation to be persistent, especially because the US labor market is undersupplied, as many workers left the labor market during the pandemic and the market has not recovered since (see Fig. 1). Further, the 4Ds are driving prices: **D**emographics, **D**eglobalization, **D**ecarbonization and **D**ebt (government borrowing). The baby boomers are retiring (reducing labor supply), deglobalization leads to more supply security, but has its price, and the long-awaited energy transition makes energy more sustainable, but also more expensive.

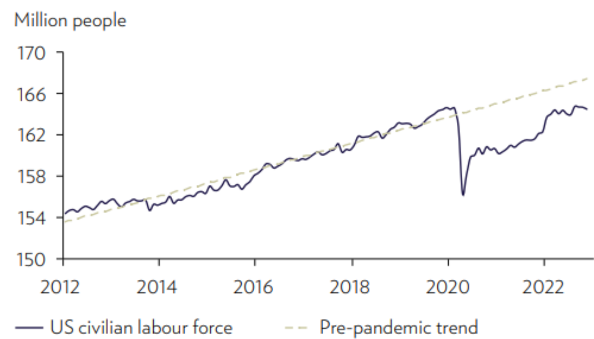

Fig. 1) *Labor force gap compared to pre-pandemic trend growth, Source: Bank Julius Baer / CIO Weekly 14.12.2022*

"Market participants are too optimistic on US interest rate cuts in H2 2023"

Based on this pessimistic view on inflation, we must assume that market participants are too optimistic on US interest rate cuts in H2 2023 (see Fig. 2).

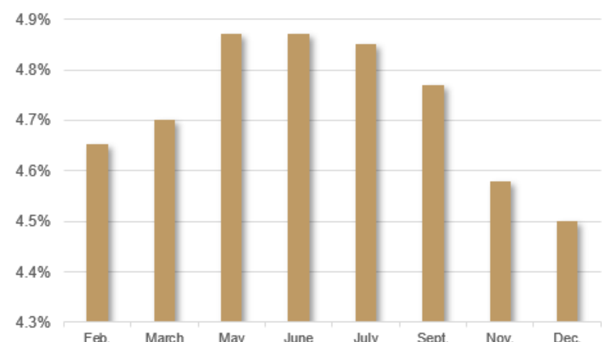

Fig. 2) *Implied FED Fund Futures 20.12.2022, Data Bloomberg, Chart Capicura Partners*

The rhetoric from the various central banks last week was unequivocal. Inflation is persistent and institutions will continue with both interest rate policy and balance sheet management (Quantitative Tightening - QT) until inflation is comfortably under control. Only the SNB has some leeway, as inflation in Switzerland is relatively modest.

The focus of central banks is clearly on inflation control and they accept a "stalling" of the economy. Thus, a global recession in 2023 is realistic and the inverse US yield curve (2-year yield @ 4.25% / 10 year @ 3.65%) also indicates that a recession could be imminent. The NY FED recession probability is nearly back at financial crisis levels (see Fig. 3). As if this was not bad enough - if inflation cannot be tamed, stagflation (no growth with inflation) remains a possible scenario.

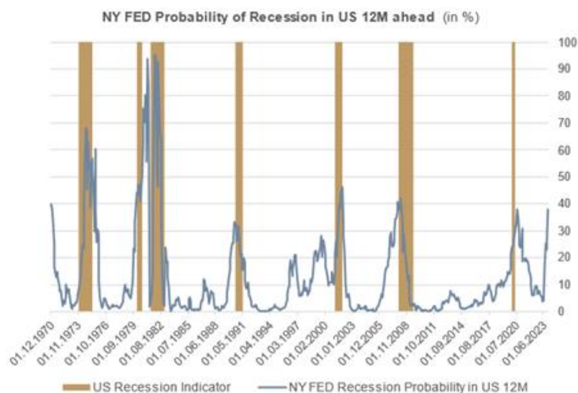

Fig. 3) *NY FED recession probability next 12M, Data Bloomberg / Chart Capicura Partners*

Since the US FED is ahead of the ECB in terms of interest rate hikes (FED has raised 425 basis points since March 2022), EUR rates will rise relative to US rates, which will be supportive for the EUR. The USD had a positive performance this year, but the new starting point argues for a USD with (further) downside potential. The past and ongoing central bank policy has ended the negative interest rate environment and made fixed income yields "investable" again. Cash and bonds have thus once again become asset classes where nominal returns can be achieved.

«Equity markets remain in consolidation mode»

For the time being, the stock markets remain in a consolidation phase, which started at the beginning of 2022. The valuation correction is well advanced, but we fear that US earnings expectations 2023 remain too high. While these have been steadily reduced since mid-year, 5% earnings growth is still expected, which seems unlikely even in a mild recession. While valuations in the US are still somewhat high (S&P500 trades at P/E 2023 of 17x), European equity markets are quite "cheap" with P/E 2023 of 10x. Also, technically the stock market does not look very attractive and therefore we are convinced that cash and fixed income are good asset classes to bridge the next 3-6 months.

«Where do Digital Assets go?»

In our Q1 2022 Outlook, we referred to digital assets (crypto) for the first time and highlighted the attractiveness of the still very young market. So far, we have refrained from implementing this asset class into our strategic asset allocation. Last quarter's FTX scandal around Sam Bankman Fried (SBF) demonstrated that this sector is still in its infancy. The euphoria at the beginning of the year has faded and the term "crypto winter" has emerged. While we understand the outrage and disappointment of market participants, we are convinced that this sector is developing important technologies, which are particularly crucial in "gaming" and the "metaverse." Further, the FTX scandal will lead to more regulation and decentralized solutions (DeFi). Accordingly, we are not writing off this new asset class.

«Q1 2023 to remain challenging»

Although it would be a great Christmas wish, we unfortunately cannot give the "all clear" sign for the first quarter 2023. The environment remains challenging, but we are convinced that such an environment also offers opportunities. The bond market in particular offers distortions that at times present equity-like returns.

However, caution remains the order of the day for strategic positioning, which is why we are sticking to our defensive asset allocation. In the meantime, the increased liquidity should be invested efficiently and "on sight" in fixed-income investments (short maturities with an element of pull to par).

Asset Allocation	
Cash	15%
Fixed Income	20%
Equities	40%
Alternative Investments	25%

Fig. 4) *Suggested asset allocation for a Balanced Portfolio in Q1 2023*

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