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Capicura Partners – Outlook 3rd Quarter 2023

June 19, 2023

Divergence between real economy and equity market

- ***Inflation rates fall, core inflation remains stubbornly high***
- ***Excess liquidity from pandemic still in the system – leading to irrational market behavior***
- ***FED has little interest in further asset price inflation***
- ***The US-Dollar is dead – long live the US-Dollar***
- ***Increase alternative quota at the expense of cash***

Fundamentally, not much has changed since the end of March, except that an expansion of a global banking crisis was contained and a possible US sovereign debt default averted at the last moment. The late but decisive action of central banks, falling energy prices and the easing of the supply chain situation have led to falling inflation rates worldwide. However, the levels are still double the 2% long-term target for the US Federal Reserve and three times that of the ECB. Moreover, core inflation (excluding food & energy) remains stubbornly high. This confirms our view that short-term rates will remain higher for longer. The Fed's "rate hike pause" at the June meeting is encouraging, but FED Chairman Powell's rhetoric indicates that one or even two more rate hikes are imminent (which is not yet properly reflected by financial markets). The same applies to Europe, where no end to interest rate hikes is in sight. Switzerland remains the exception. There, the SNB will soon run out of arguments for further rate hikes given its inflation at 2.2% (nevertheless, we expect another 25bp hike this week).

«2% target inflation remains wishful thinking»

The FED is facing a "Mission Impossible" and could further burden the already weakening US economy with additional interest rate hikes or even lead it into the much anticipated recession (probability of such a recession in the next 6 - 9 months still very high). In addition, the situation on the labor market remains tense.

Against this background, we feel confirmed in our assumption that inflation will remain above the central banks' 2% target for longer.

«Recent rally was driven by a handful of growth stocks»

Despite weak economic growth, equities are "climbing the wall of worry". European equity markets have moved back to levels last seen before the start of the strong rate hike cycle. The Nasdaq100 index is trading just 9% below its 2021 highs, even though interest rates have risen 500 basis points since March 2022 (see Fig. 1 for current divergence). Why have the stock markets or individual indices performed so well over the last three months?

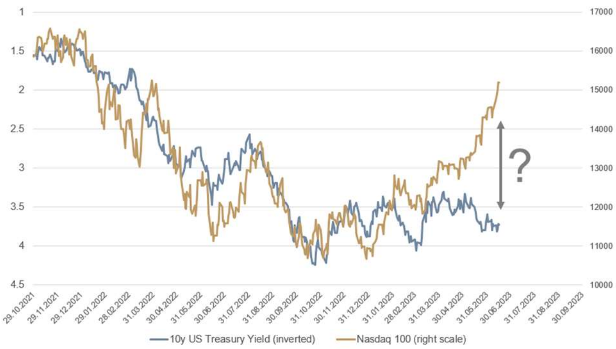

Fig. 1) Nasdaq100 vs. 10-year US Treasury yield (inverted)
Data: Bloomberg / Chart Capicura Partners

One explanation is probably the excess liquidity that is still in the system since the pandemic and which has not yet been siphoned off. In addition, there is likely to have been a reallocation of capital from "no longer investable markets" such as Russia and China to Europe, the US and Japan. However, the most important driver was the topic of artificial intelligence (AI) which was able to boost shares of large-cap names such as Apple, Nvidia, Microsoft, Meta and Alphabet in particular. In addition, many market participants (including us) were too cautiously positioned at the beginning of the quarter due to the simmering banking crisis. We are still only beginning to see how and where AI will change our lives. Goldman Sachs expects it to contribute 7% to global GDP over the next 10 years. Still, the price movements and valuations of some individual stocks are reminiscent of the year 2000.

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«Sentiment indicators show short term complacency»

Interestingly, the overall market could not quite follow this recovery until recently. The lack of market breadth makes us cautious as just eight companies are responsible for 97% of the S&P500's +16% YTD performance! (see Fig. 2)

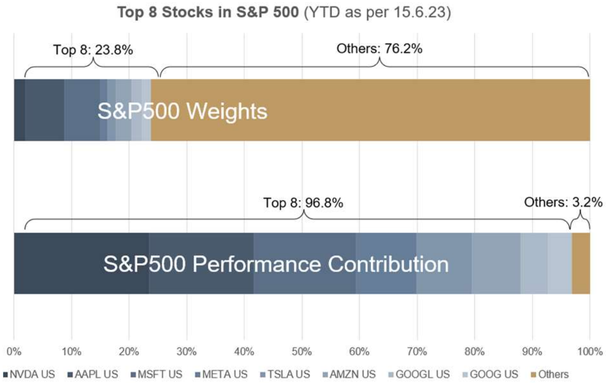
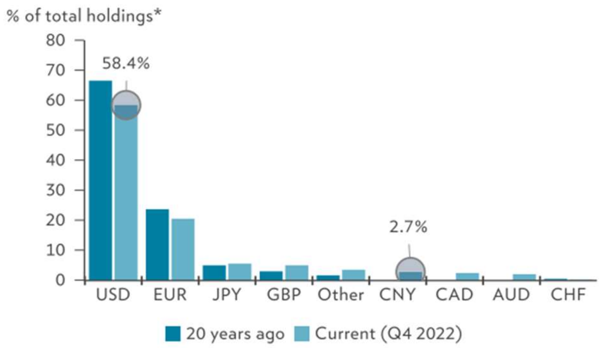


Fig. 2) Impact of largest eight S&P500 members on the index performance. *Data Bloomberg, Chart Capicura Partners*

If the stock market anticipates an economic recovery, it should also be supported by the small and midcap segment. It is therefore appropriate to take a closer look at the current sentiment, as we know, that market psychology should not be neglected. Various indicators look a bit too positive, which is negative from a "contrarian" point of view → Put/Call Ratios low, CNN Fear&Greed Index at "Extreme Greed" (highest level in twelve months), VIX Index (volatility at levels of 2021), AAII US Investor Sentiment Bullish Readings (highest value since December 2021). These indicators show that investor sentiment has brightened markedly over the past three months, making markets vulnerable to corrections. Fundamentally, valuations, especially of the S&P500 with a PE ratio of almost 20x est. 2023 earnings, remain elevated. Furthermore, the central banks (above all the US FED) are unlikely to be interested in significantly higher equity markets, as their fight against inflation would be severely jeopardized by a further rise in asset prices (positive "wealth effect").

«The US-Dollar is dead – long live the US-Dollar»

Since the beginning of 2023, the status of the USD as a global reserve currency has (yet again) been questioned whether it qualifies as “THE” reserve currency going forward. The fact that certain commodity contracts now also trade in CNY (Chinese Renmimbi) combined with the topic of digital assets and digital central bank currencies led to a consensus view that the USD is prone to lose importance over time. While possible, we struggle to see alternatives to the Greenback. The CNY is not freely tradable and hence cannot qualify. The EUR remains a structurally weak currency and suffers from the heterogenity of the Eurozone economies and a "one fits all" monetary policy. Digital assets are struggling to find credibility, especially after last year's FTX scandal followed by more recent US regulation. Although the comparatively low inflation rates and sovereign debt ratios make the CHF a safe haven, the market is too small and the CHF is therefore unsuitable as a reserve currency. So for now, we expect the USD to remain unrivaled and to remain "THE" reserve currency for quite some time.



Source: IMF, Julius Baer; * excluding unallocated reserves

Fig. 3) Currency reserves today versus 20 years ago.
Source: Research Focus Bank Julius Baer 17.5.2023

«Don’t get caught up in euphoria»

Although we are pleased about the current stock market strength, we do not fully trust it and try not to get sucked into the euphoria. We remain cautiously positioned with an equity allocation of around 40% in a balanced mandate but are increasing risks in the alternative space. We have recently increased the AI quota in our mandates with a long/short equity fund (small / mid-caps in the German/Austria/Switzerland region).

Asset Allocation	
Cash	*10%*
Fixed Income	*25%*
Equities	*40%*
Alternative Investments	*25%*

Fig. 4) *Suggested asset allocation for a Balanced Portfolio in Q3 2023*