CIO NOTE
AUGUST 2022

INTRO

The first six months of 2022 were particularly challenging for investors: central banks became increasingly determined to rein in inflation at a time when several factors (including Ukraine conflict) kept pushing up inflationary pressures.

As a result, US Stocks and global bonds had the worst start to a year in more than 50 years (between the start of year and mid-June the S&P500 Index was down 23%).

Since then, a partial recovery took place: US 10-year bond yields hovered around/just below 3% all summer (vs 3.5% in mid-June), and S&P500 is now down 15% YTD. Sector-wise, performance has reversed what we saw in the sell-off earlier in the year, with tech and consumer discretionary sectors faring the best.

At first, the summer bounce seemed to be based more on short-covering rather than any fundamentals. This seems true given the technical nature of the rally, where sentiment and positioning was extreme in mid-June and the rally has stalled around technical levels (200 DMA)

Source: StockCharts.com

Crucially, the summer rally coincided with a softening of inflation and interest rate expectations. For the equity rally to stick, markets must be right not only about inflation, but also about the severity of next year's recession (i.e., inflation need to have peaked, and the Fed (Federal Reserve) must recognise this at the right moment and avoid a recession.)
Any hopes of the Fed tightening less than anticipated are pinned on the anticipation that inflation cools down suddenly.

This seems unlikely because:

- Previous episodes of high inflation like 1970s show it took 2 years of tightening to cool down.
- Commodity inflation looks to stay high given further gas shortages in winter, and OPEC (Organization of the Petroleum Exporting Countries) constraining supply to keep oil above $100. Higher energy prices feed into other prices with a lag, so inflation is stickier.
- Continued USD strength acts as further tightening for the rest of the world. It also demonstrates that real money continues to seek safe havens and risk appetite remains subdued.

We expect inflation to fall, but not fast enough for the Fed to blink before the economy buckles: downside surprises in inflation will be the outcome of a recession, not a leading indicator to avoid it. This will be covered in more detail in this note.

MACRO

FED CHAIRMAN POWELL DAMPENS THE SUMMER MOOD

Before we look into the future, we must cover the most recent news, and that includes the Fed Chairman Jay Powell's address at Jackson Hole a couple of days ago.

Powell adopted a hawkish tone, stating that "high inflation has continued to spread through the economy", that "there is a job to do to bring inflation back into control" and that "this will entail a sustained period of below-trend growth".

The speech was unusually short (under 9 minutes) and scarce in details as to how the Fed plans to improve its Policy Framework. I mention this, as equity markets (which were down 3% on Friday after Powell's speech) remain nervous about a Fed whose credibility is under close scrutiny: it over-tightened in 2018, over-stimulated in 2021, and Powell is now trying to emulate ex Fed Chairman Paul Volker at a time when the US economy is already losing momentum.

All in all, Powell's decision of trade-offs will be even harder once inflation begins to ease down: stop tightening too early and risk runaway prices; stop too late and risk pushing millions into unemployment for no reason.

WHAT NOW FOR THE FED, US GROWTH AND US INFLATION

The Fed needs to be aggressive to regain credibility and stay hawkish until inflation establishes a clear downward trend, or the economy softens a lot.
Although the Fed will likely drive-up rates to well above 3%, we doubt that short rates will stay there for too long: emerging economic weakness suggests that interest rate expectations are now not far from neutral levels.
Some might point to the fact that current economic indicators suggest that activity is still decent. However, let's remember the following:

- US economy had plenty of momentum, with strong payroll growth and healthy balance sheets after the vast Covid-19 fiscal stimulus of 2020 and 2021.
- Albeit incredibly aggressively, the Fed only began to tighten policy 5 months ago.

- It will take some time before higher borrowing costs begin to bite, but they most definitely will. Higher borrowing costs make it more difficult for firms and consumers to pay back their debts. Furthermore, higher rates make asset prices fall and asset markets less liquid, so companies and households feel poorer and less willing to spend.

Supply constraints have played a big role in driving inflation higher, and this dislocation will eventually abate, as trade and manufacturing infrastructure bottlenecks ease. Also, commodity prices are a wildcard, but base effects should help.

In addition, there's evidence of overstocked inventories, which should bring down goods prices once retailers start rolling out discounts.

To conclude, with aggregate demand expected to weaken, peak inflation should be behind us (it is indeed hard to see how inflation would roar through a recession).

Calling a peak in inflation does not mean a quick return to the low levels of the past: inflation will converge to a much higher “steady-state” level than we are used to, due to different factors (from onshoring of goods production to populist policies like higher minimum wages and universal incomes). The 5-year/30-year spread in US Yield curve, which has been steepening, seems to reflect this structural reality.

CONTINENTAL EUROPE IS DRIFTING INTO RECESSION UNLESS PUTIN CHANGES TACK

In Europe, the squeeze on natural gas supply continues to pressure prices higher, putting pressure on policymakers to soften the impact in cost of living.

If European inflation moved into double digit territory, a 10% decline in real incomes could ensue. Based on a simplistic rule of thumb, the impact of consumer spending in European GDP (Gross Domestic Product), would translate into a drop in European GDP of around 4%. This would make a looming recession in Europe almost as severe as the one after the Great Financial Crisis in 2008.

Back then, monetary easing was deployed to support growth, but nowadays rate hikes are needed to fight against inflation. This means that fiscal policy is the only tool available to support demand. However, I remain unsure as to how much fiscal space the governing authorities will utilise (Covid-19 support policies did not leave public coffers in top shape to say the least).

We started to see some negative developments in Italy, which is yet again engulfed in political uncertainty: a new general election has been called after Five Star boycotted a confidence vote on Draghi’s government.

Politics remain a risk in Europe. ECB (European Central Bank) tools may partially be able to cap government bond spreads, but they will fail to stop volatility in a post-QE (quantitative easing) world.

A VERY TOUGH JOB FOR BRITAIN'S NEXT PRIME MINISTER (PM)

Attention has been mainly focused on who will be the next leader of the Tory Party and prime minister.

In any case, the challenges for PM Truss or PM Sunak are huge: UK inflation hit double digits for the first time in 40 years, and a breakdown of CPI (consumer price index) components shows a striking breadth of categories experiencing price gains. Combined with the recent wage strength, there is a clear risk of wage-price spiral taking hold in post-Brexit Britain.

If this was not enough, energy bills are set to surge again in October and push inflation even higher.

All this makes a 0.5% hike in September by the BoE (Bank of England) likely, with an even larger 0.75% hike a possibility. Eventually, though, the BoE will probably fail to deliver the interest rate hikes that are currently built into the front end of the curve.

CHINA OPENING THE FISCAL TAP

Chinese activity data in July (latest print) underperformed expectations, so PBOC (China's Central Bank) trimmed interest rates across the board. The rate cuts reflect policymakers' negative view on growth amid concerns about the property sector. Chinese State Council also unveiled new fiscal measures totalling around 0.8% of GDP.

Chinese government has so far refused to implement large-scale property sector bailouts, so weak private demand, and confidence (due to property values downturn) will remain a significant headwind.

MAIN RISKS TO OUR CENTRAL MACRO VIEW: DEEP STAGFLATION

Our central case for assets is clearly not a rosy one, but it is not the worst case either. That would correspond to a situation where factors outside Fed's control (Geopolitics, for instance) contribute to inflation not cooling down despite much lower growth.

Should the Fed push rates towards 4%, the depth of recession will increase and the downside risk for both bonds and equities will increase.

Another risk is the re-intensification of the energy crisis, which would make controlling inflation more difficult

The drop in oil prices has stalled in recent weeks (at time of writing this, Oil price is $10 higher than it was a couple of weeks ago) and it seems that Saudi Arabia does not want to see oil prices slip much below $100/barrel.

ASSET MARKETS

EQUITIES

INTRO: VOLATILITY TO CONTINUE, BUT MID-JUNE LOWS ARE A CREDIBLE MARKER FOR BOTTOM

Enormous P/E (price-earnings ratio) compression has taken place this year (in an extent comparable to 2000 and 2008 corrections).

Equity volatility is likely to persist in the 20-30% range on the VIX (Chicago Board Options Exchange's Volatility Index) for the rest of the year.

Technical analysis and historic corrections suggest that the June low point is still a credible marker for the bottom, but a re-test could be likely.

Positioning and sentiment is still extremely negative and hence supportive as contrary indicators: pain trade is up in equities.

Over the next 5 years, earnings growth should be the main driver of equity returns as multiples are unlikely to re- or de- rate significantly (valuation multiples at longer term averages and longer bond yields is likely to remain around current level with above post-GFC (Global Financial Crisis) inflation levels but limited growth).

Expect 5-Year forward CAGR (Compound Annual Growth Rate) earnings growth of mid to high single digit per annum. Currently nominal measures are helpful, and earnings forecasts have been very resilient.

THE MAIN RISK: A DEEPER RECESSION IMPACTING EARNINGS

In our view, the most likely outcome is a “run of the mill” recession in 2023. Historically, EPS (earnings per share) falls by 8-10% in such recessions, which include 1982, 1990 and 2001.

If the US plunges into a deep recession (i.e., EPS falling by 20% or more), then much more pain is in store. Nevertheless, in this case, long bond yields would also likely fall, thus providing some support for equities.

Other main risks would be a significant war escalation (in Ukraine or Taiwan) and a China meltdown.

A CHURNING PATTERN FOR EQUITIES

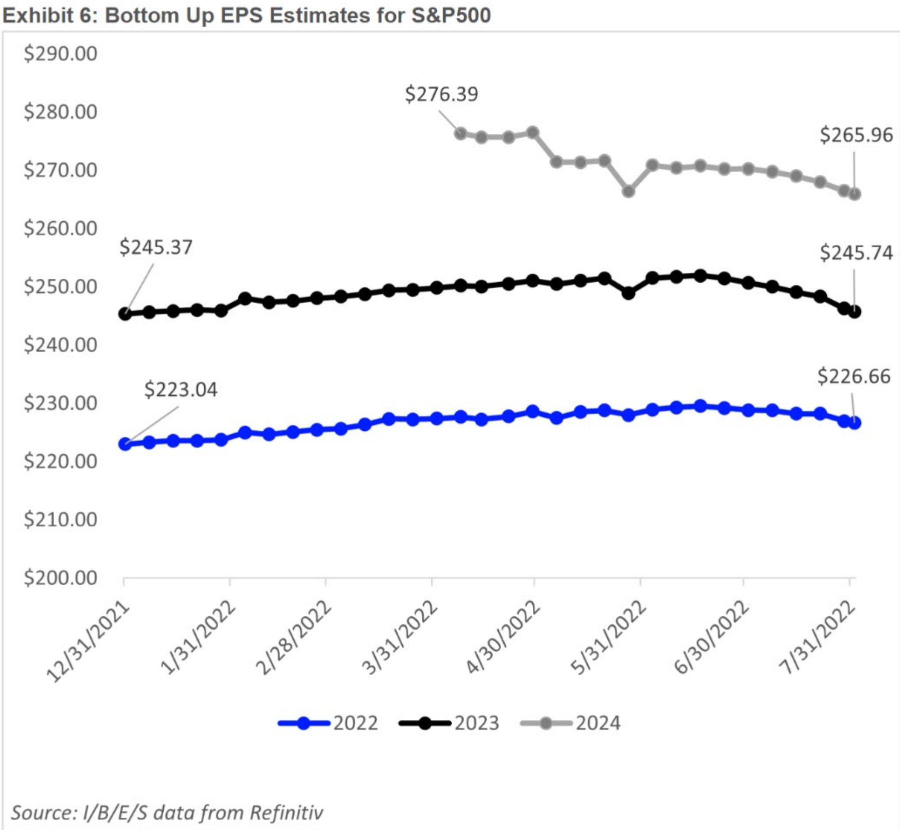
US economy is softening, and earnings growth is weakening. This could imply range-bound equity markets until a new catalyst appears. Such new catalyst could be a decisive drop in inflation or evidence of much weaker job market.

AVOID CYCLICALS, STICK TO CORE

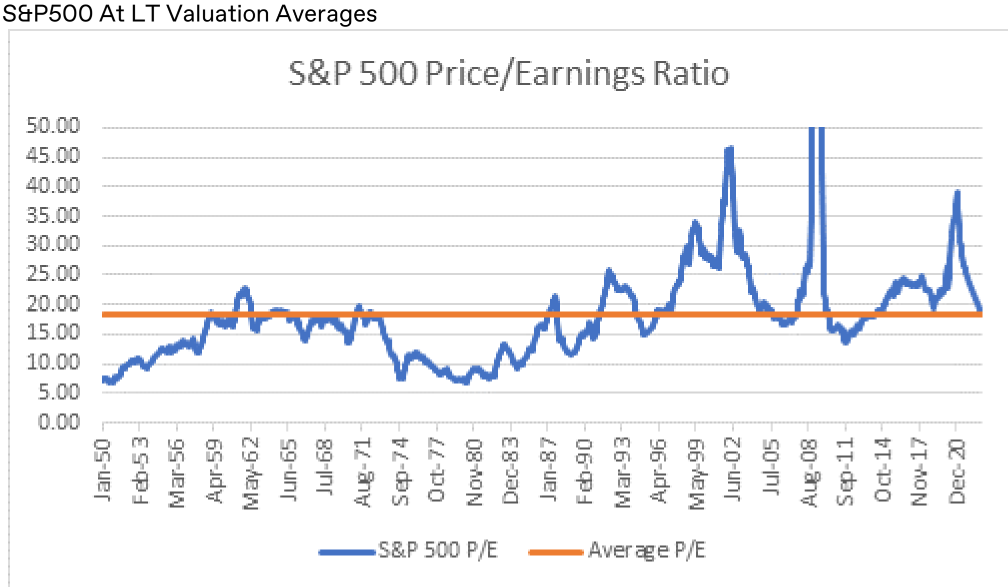
- Avoid cyclical and economic exposure until PMI (Purchasing Managers' Index) reach low-40s: too early for now.
- Stick to the Core Equity solutions: STAR and Growth Plus. This is a perfect blend of high-quality defensives and growth equities which provides a robust balance to face the plethora of eventualities in this period of uncertainty.
- Structural Growth is a good longer-term opportunity as can grow even in a lower economic growth environment which is likely to arrive.
- We have moved on to an opportunistic mindset: there could be further dislocation allowing excellent longer term entry points.

SOME KEY GRAPHS

EPS Estimates: Resilient Earnings or Delusional Consensus?

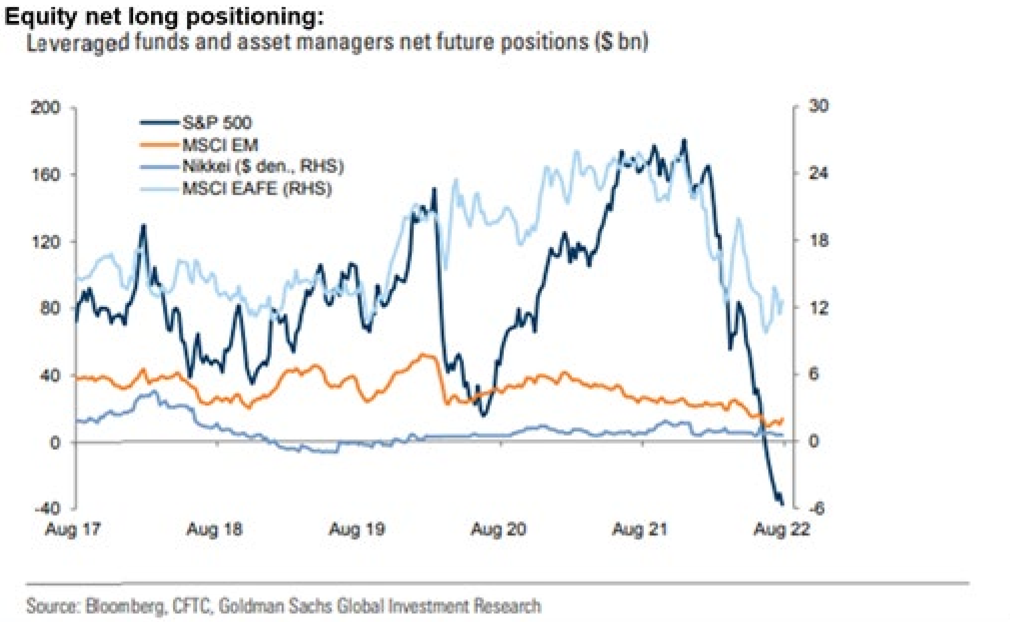


S&P500 At LT Valuation Averages



Source: Bloomberg

Equity Positioning remains very bearish



Source: Bloomberg

FIXED INCOME

INTRO: EVENTS DEVELOPING AS EXPECTED (EXCEPT IN UK)

01 Growth slow-down

- Economic data pointing to protracted slow-down with the probability of a recession in a range of 30-50% (even higher in UK and Continental Europe). Data will remain volatile which is consistent with a shift in momentum from above potential growth to below potential.

02 Inflationary pressures peaking

There has been a gradual improvement in forward looking indicators such as supply chain pressures (ISM (Institute for Supply Management) and corporate releases), input and output prices (PPI), inflation expectations, wage growth (particularly the US) and commodity prices (ex. gas prices in Europe in particular). Europe faces significant pressures from the sharp rise in market prices and this will particularly be evident in the case of the UK push inflation up even further in the coming months.

03 Speed of monetary tightening accelerating

- Central Banks have stayed true to their rhetoric (despite some market speculation early on that the BoE and ECB were merely jaw-boning and would not follow through).

DURATION STANCE

The increase in duration over the past couple of months was appropriate given the forward looking growth and inflation indicators. Duration is still below benchmarks (intermediate and certainly wider benchmarks). A further increase in duration (up to 0.75 year) would be consistent with capturing a peak in the rate cycle later this year or early in 2023.

Our base case for government bonds is that maturities up to 10 years appear to have priced in both higher official rates over the next 18 months or so. As well as the risk of policy mistakes should growth remain at subdued levels throughout 2023. The flattening of the yield curve has addressed both these outcomes in the 3 main markets, the US, Eurozone and UK. We expect a lower level of government bond volatility as we end 2022, as both policymakers and markets alike will respond to mounting evidence that challenges this base case. An inversion in the yield curve is likely to become more apparent in coming weeks.

RISKS TO BASE YIELD VIEW

Yields could shift higher should there be a more concerted view that inflation has become embedded alongside moderate economic growth, in which case curves will most likely steepen to reflect an element of loss of faith in policy makers.

At the other end, a more pronounced economic contraction should take pressure off central bankers to tighten so aggressively, which would most likely result in a “bull steepening” of yield curves, led by larger falls in shorter-dated maturities.

PORTFOLIO ALLOCATION

01 Investment Grade

- The allocation was raised over the past couple of months, as a response to the macro backdrop opening up and crucially the valuation gap that had opened up, i.e., in response to a dramatic re-pricing of interest rate expectations.

02 Financials

- Q2 2022 bank earnings were positive almost across the board (with expected disappointment from Credit Suisse amongst the big names): core balance sheet ratios remain strong for both US and European banks. Our strategies have been o/w subordinated debt relative to senior debt.
- Banks as a key economic sector with pricing power are in a good position:
  - Key regulatory ratios have improved over the past few years
  - Greater resilience of balance sheets
  - Significantly greater liquidity and diversified access to capital
  - Improving Net Interest Margins
  - Higher NPL (non-performing loans) provisions and greater transparency on loan books as part of regulatory requirements
  - Diversified and resilient earnings drivers
  - Resilience in the face of significant stress tests by regulators
  - Subordinated bonds are being called on time by the large banks
- We are closely monitoring areas that may require a reappraisal:
  - Impact of a deeper economic downturn on earnings and profitability
  - Changes in underlying delinquencies and loan book deterioration
  - Any dilution of regulatory oversight
  - Non-calls by banks (there have been sporadic non-calls that have not had a wider impact, but we are monitoring each holding versus the broader market)
- Price volatility has been higher largely driven by a dramatic reappraisal of rate expectations, leaving valuations at attractive levels both on an absolute basis and on a risk adjusted basis. We are closely monitoring both valuation parameters to adjust positions appropriately.

03 Corporate Hybrids

- The supportive factors remain:
  - Our focus is on key economic sectors such as utilities, telecom and energy
  - Includes regulated industries
  - Senior paper is firmly in HG (high grade) territory with hybrid issuance serving multiple purposes
  - Ability to pass on price rises to consumers relative to cyclical companies
  - Leverage remains within the ranges we expected
  - Refinancing risks are low and liquidity levels at the corporate level are high
  - So far, bonds are being called on time
- There has been a reduction in hybrid exposure this year and as calls continue to happen, we will encourage a shift into senior bonds if it makes sense on an absolute and relative valuation basis. If it is right to switch into new hybrids (in the same issuer) or an alternative on a risk/reward basis we will say so.
- At present the implied coupons are higher across the board which is positive for investors. Should the bonds not be called, they will end up with higher income from a solid entity albeit with a longer new call date (but not beyond 5-years)
- A non-call should mean that the full issue size will be viewed as debt and raise leverage. Given the companies we are involved in the increase in leverage is non-material. The spread widening YTD has partially reflected this concern
- Selling by benchmark driven investors is a risk, particularly in EUR-denominated issue

– We will continue to monitor risks and will make a risk/reward judgement on a case-by-case basis, but the base case remains intact.

04 Index linked bonds

– Index linked bonds have suffered in line with conventional bonds driven by the shift in underlying sovereign bond yields and would have not provided shelter.

– Looking ahead, if the prevailing view is that interest rates will be pushed even higher and as a result yields will rise, it will undermine index-linked debt as the rise in real yields will more than offset a higher CPI profile.

– It is not sufficient for inflation to remain static for the return stream to be positive. Actual inflation has to be above implied inflation rates to drive positive returns.

– On a risk/reward basis tactical trading in index-linked bonds continues to be unattractive but remains a viable strategy for long-term liability mandates.

05 EM (Emerging Markets) Debt

– A weaker global economic backdrop, tighter monetary conditions, a strong dollar, potential for lower commodity prices, a less supportive China economic model, fears over energy, food security and greater debt vulnerability are all concerns for a wider exposure to EM bonds.

– Nevertheless, we are looking for 1-2year paper that is trading at discounts in sovereign hard currency paper.

– Government bonds (and therefore Investment Grade Corporate paper) have responded quickly to the shift from a more aggressive Fed.

06 Non-Financial High Yield

– Hidden leverage in credit markets is difficult to pinpoint, but a looming risk for financial distress exists if banks cut off funding to the shadow banking sector.

ALTERNATIVES

HEDGE FUNDS

- With macroeconomic and policy uncertainty remaining elevated, and by extension volatility remaining prevalent in traditional asset classes, we continue to see an extended window of opportunity for outperformance from hedge funds.
- However, not all strategies are alike, and it is primarily uncorrelated strategies which we expect to continue to benefit from the more difficult and volatile market backdrop.
- Of the more directional strategies, Global Macro and Managed Futures funds can benefit from some of the significant swings we have seen across multiple asset classes. Non-directional strategies such as fixed income arbitrage, volatility arbitrage and equity market neutral are enjoying a rich opportunity set.
- Conversely, long-biased strategies in equities and credit have struggled so far this year and have been forced into significant risk reduction (e.g. Tiger Global), and in some cases we have seen complete fund closures such as that from Melvin Capital.
- The risk to this view is a swift resolution to the inflation problem and a dramatic re-rating of bonds and equities, which would see much of the current hedge fund positioning offside and vulnerable to losses and/or failure to capture the upside. A much more range bound environment could also dampen return potential for most managers outside of short-term trading and relative value mandates.
- We maintain our core values in our UCITS hedge fund program of allocating to true alpha generating strategies which are much less directional than the hedge fund industry as a whole and therefore exhibit less beta and correlation.
- This has so far yielded mildly positive results for the year, and we believe that aiming for consistent, low-to-mid-single digit returns will be increasingly valuable in client portfolios as we go forward.
- For professional clients with a higher risk appetite, there are several offshore strategies with flexible mandates across futures, equity, credit, and commodities, which can take more aggressive contrarian bets and offer strong risk/reward in the current environment.

PRIVATE EQUITY

- We continue to see clear evidence of a slowdown in Private Equity deal activity, fewer exit opportunities, especially via IPOs, and an adjustment of valuations to more realistic levels, in line with the de-rating of publicly traded companies
- While the environment is more difficult, most institutional private equity fund managers have either raised capital or are still finding appetite from large allocators for their long-term approach to investing. There is therefore a significant amount of dry powder at hand in the industry and we have begun to see evidence that this money is being put to work in line with investment mandates, which should provide some support to those private companies with strong prospects.
- In addition, private equity funds and their underlying companies have more flexibility to take long-term decisions to ensure future success, not being beholden to the quarterly earnings cycles and shareholder scrutiny seen in the public markets.
- Given the improved valuation entry point, we feel that that now is an opportune time to be allocating to skilled managers who have a track record of operating through multiple cycles and can deploy investor capital in a judicious manner in the coming years.
- We currently favour low-levered buyout managers able to take advantage of distressed public company valuations, tech-focused managers who can now invest at much better entry points, and other private strategies in real assets such as renewables, forestry and real estate.

CURRENCY MARKETS (FX)

The USD keeps making headlines. Most recently, it has broken below parity versus EUR.
We suspect that USD trend could have further to run until Fed's tightening campaign relents (Fed is likely to remain the most hawkish central bank globally until US moves decisively lower).
For the moment, regions like UK and Continental Europe are more vulnerable to the stagflationary impulse of the global energy shock, and have lower structural growth rates than the US.
Next year, however, a cooling US economy should prompt the Fed to back off, setting the stage for a downturn in the USD.
We continue to maintain a bearish outlook on GBP: UK CPI shows no sign of stopping the current trend just yet.

CONCLUSION

There are no obvious "back to school" trades at this moment in time. Rather, we must continue, as we have done, looking for good businesses to own/lend to and focusing on long term prospects over short term swings.

Our core exposures are not changing:

- Bonds issued by strong companies without significant risk of default.
- STAR names with resilience and pricing power. Growth Plus names should keep growing at time when growth difficult to find and pricing power wise.
- Portfolio diversifiers that complement (like Commodity overlays, Gold or Alternative Investments).

The transition towards slower growth should benefit our investment stance: markets will begin to discriminate between good and bad credits, between resilient and not so resilient earning streams.

Volatility is not likely to abate soon, and this will lead to good entry opportunities

Kind Regards,

PAU MORILLA GINER
Chief Investment Officer