



**CBH** | Investment  
Management

RESEARCH

## QUARTERLY INSIGHT

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2<sup>nd</sup> Quarter 2023



Face Lift - Larry Otoo  
2010. Acrylic on canvas 118 x 146 cm  
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Photo: P. Bitz

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# Central Banks Facing a Tough Balancing Act

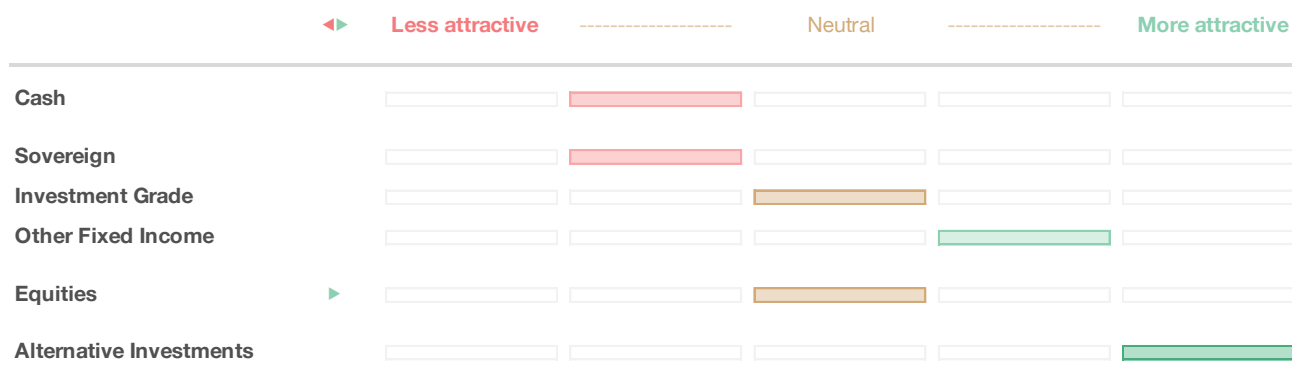
Major central banks are facing a tough balancing act. They have to deal with sticky core inflation, a slowing economy, and woes in the banking sector which threatens financial stability. The sheer scale and speed of central banks' rate hikes over the last 12 months were bound to cause great economic damage and lead to some crack in the financial system at some point. The old saying that the Fed hikes rates until something breaks seems to be holding true. The Fed has repeated many times that its priority is to fight the highest inflation shock in 50 years and that it is willing to pay the price in the form of a shallow recession. We think that this economic damage is what the Fed needed to get inflation down quickly. The recent cracks in the US banking system serve as a reminder that policy rates have already reached a significantly restrictive level.

Rate markets are pricing in that the Fed will reach peak Federal Funds Rate (FFR) at 5.25% at its next meeting in May and start to cut rates as early as July to sustain the economy. In our opinion, this view does not sufficiently take into account the starting point for the economy and inflation. The tightness of the labor market heralds a recession to bring down sticky core inflation. It is thus probably too optimistic to price in the possibility that the Fed will rescue the economy from a recession it is voluntarily engineering at the first sign of contraction. We also consider current measures of inflation expectations to be quite optimistic; for example, despite sticky core inflation and a labor market that remains extremely tight, the 10-year breakeven rate has fallen back to around 2.3%. Even more concerning is the pricing of the equity market, which is not pricing in the 30% earnings drop typically seen in a recession. EPS growth expectations for 2023 in the US and Europe are still barely negative, and the negative earnings revision trend is showing signs of reversing.

The common denominator between the fixed income and the equity markets lies in the expectation that the Fed will cut rates and rescue the economy before the end of the year. In our view, market expectations for rate cuts are too optimistic and underappreciate the severity of the longstanding trade-off facing central banks. Their fight against inflation means they are actively generating a recession, not trying to avoid one. The risk in the second quarter is that markets' dovish hopes could be cold-showered, leading to a repricing of the Fed's path, which would hurt risk assets and send short-term rates higher.

## Convictions

- Economic momentum continues to slow down in the US and Eurozone
- Market pricing for Fed cuts this year is too optimistic
- Core inflation to remain sticky in the US and Eurozone
- China reopening to boost global growth in 2023
- Yields in the US and Europe remain volatile
- EPS growth to be negative this year in the US and Eurozone
- The US dollar weakens more



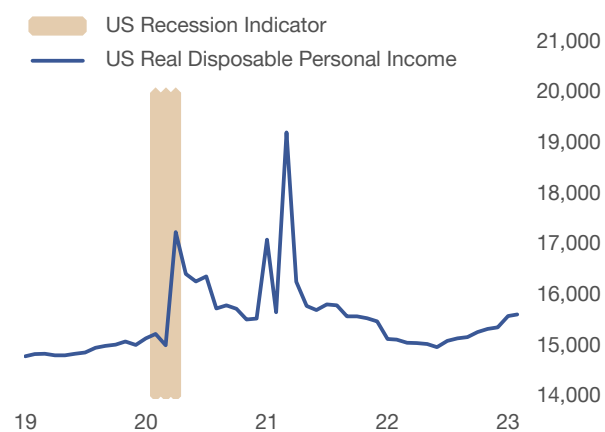
◀▶ Indicate the last change. Number of triangles indicates the movement amplitude

# Macro Outlook

## US Macro Outlook

The US economy has been quite resilient in recent quarters in the face of the worst inflationary shock in decades and the most brutal tightening cycle by the Federal Reserve in modern history. Our analysis indicates that the US economy has been sustained by healthy consumption, which has benefitted from the remaining inventory of excess savings accumulated since the pandemic. In addition, real disposable income, a good measure of inflation-adjusted purchasing power, has risen to a level higher than before the pandemic and is increasing again.

### Real Disposable Personal Income

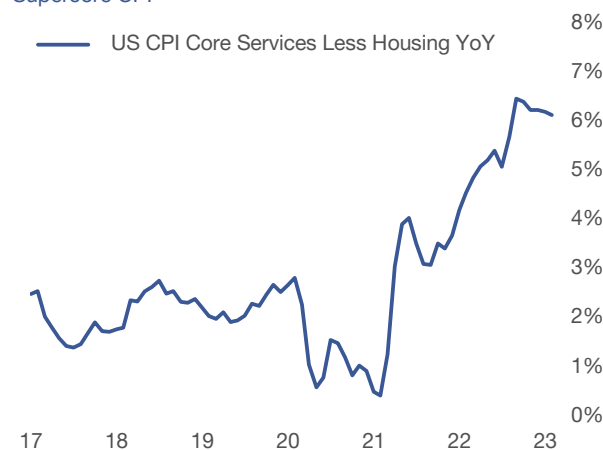


That said, we expect the US economy to continue slowing down in the coming months. The transmission channel from higher policy rates to lower credit activity, weaker economic growth, and, ultimately, lower inflation is characterized by long lags of more than 12 months. And as the Fed embarked on its tightening cycle in March 2022, the economy is just starting to feel the lagged effects of tightening monetary policy. In addition, since 4Q22, tighter lending standards have slowed credit activity and have already dampened companies' intentions to expand their business. We believe that the recent turmoil in the US banking system will accelerate the tightening of lending standards and further tighten financial conditions by a magnitude equivalent to an interest rate hike of at least 50 bps.

The market has bought into the narrative of global disinflation, as the US headline CPI peaked in June 2022 at 9.05% and core CPI at 6.63% in September 2022. Indeed, the continued normalization of supply chains in a post-Covid world continues to be a supportive factor for goods disinflation, but it is likely that the base effect of lower commodities has run its course, and we even see some goods inflation coming back, such as in the case of used cars. The real issue with inflation for central bankers is the stickiness of core measures of price pressures. As a case in point, inflation of core services excluding housing (Supercore CPI) remains well above levels that the Fed can likely tolerate and has proven to be very sticky, as it

only declined by 0.33% from September 2022 to February 2023 (from 6.46% to 6.13%). The culprit behind this inflation stickiness is the tightness of the labor market, which is preventing a necessary cool down of wage growth.

### Supercore CPI



The ratio of job vacancies to unemployment jumped again in December 2022 to 1.96 (meaning 1.96 jobs for every unemployed person), still very close to the all-time high (1.99 in March 2022). The reliable Employment Cost Index (wages and salaries for all civilian workers in all industries and occupations) was still running at 5.1% at the end of 2022, and we only see wage growth deceleration among low-skill jobs, while high-skill job wage growth is still running hot. We thus believe that, due to the structural changes in the labor market induced by the pandemic, the tightness of the job market will take a lot more time to soften, and that will contribute to the stickiness of core services inflation.

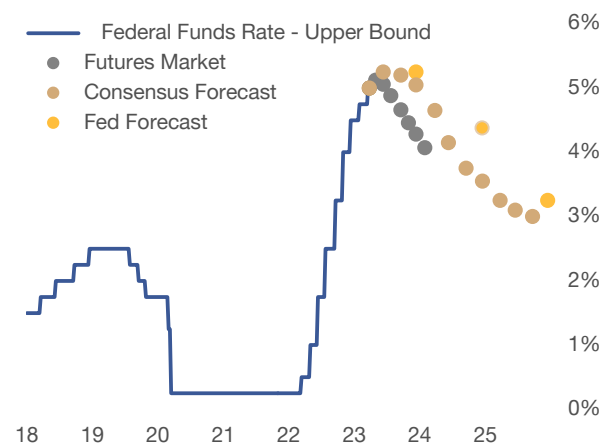
### Employment Cost Index



The Fed raised the FFR to 5% (upper bound) at its March policy meeting for the ninth consecutive time. It referenced still-elevated inflation and that additional rate hikes were on the agenda, albeit with less conviction—it dropped the reference to “ongoing increases” of interest rates, revising it to “some additional” rises. Furthermore, Chair Powell

admitted that the recent cracks in the US banking system have the potential to tighten credit conditions and thus could do some of the job for them. However, it maintained its quantitative tightening (QT) targets of \$60 billion treasury roll-off and \$35 billion MBS roll-off per month. By hiking rates and continuing QT while simultaneously providing liquidity support for banks, we see evidence that the Fed is making a clear distinction between financial stability and price stability goals. In our view, this separation contrasts with the central bank response to the 2008 bank failures and to the pandemic, when it used all its tools, including rate cuts, to stimulate the economy. In this regard, the recent increase in the Fed's balance sheet should not be considered a form of quantitative easing (QE), as it is not linked to the purchase of securities in open markets but rather to the liquidity support given to banks.

#### Fed Path



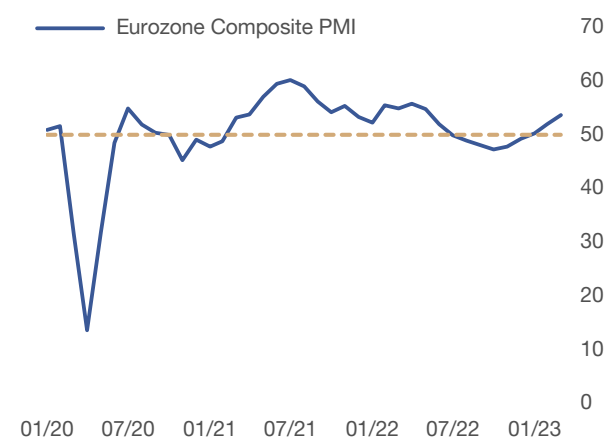
Markets have been quick to price in rate cuts as a result of the banking sector turmoil. We believe this is the old playbook from when the Fed would rush to rescue the economy as a recession hit, and we do not foresee the start of the next easing cycle this year. That said, the Fed seems to be nearing its terminal rate, as the increasing recognition that higher interest rates are starting to bite signals that the interest rate peak is approaching. In addition, when we add the effect of QT and the upcoming tightening of lending conditions in the banking system, the current “shadow” policy rate is at least 1% higher. We acknowledge that in previous cycles, when the Fed also hiked aggressively, it did not wait long before reversing course (1 month in '83-'84, 3 months in '88-'89, 4 months in '94-'95); however, we believe this time will be different due to the backdrop of sticky inflation. We think the Fed could only deliver the rate cuts priced in by markets if a more serious credit crunch takes hold and causes an even deeper recession than anticipated. We expect one or two additional hikes before the Fed pauses until next year.

#### Euro Area Macro Outlook

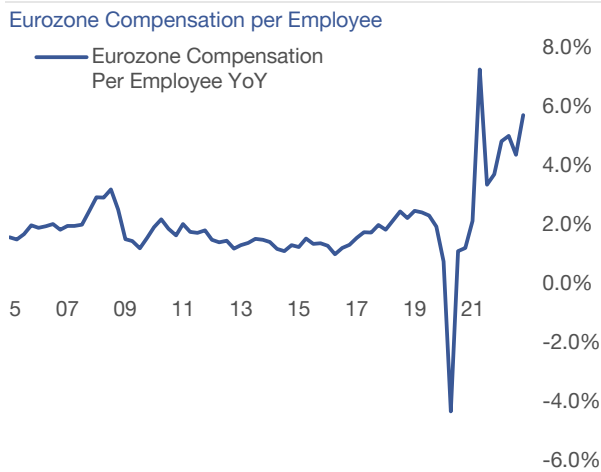
Despite the gloom at the end of last year regarding an upcoming recession in the euro area, the economy has been surprisingly resilient, mostly thanks to the collapse in natural gas prices. The efficient management of energy storage capacity and mild weather conditions led to a sharp decline of the benchmark Dutch TTF natural gas

contract to well below the level observed before the Ukrainian war. The euro area economy also proved to be more flexible than expected as industries diversified energy sources. This fall in energy costs has removed the risk of energy rationing and sustained consumption and sentiment. To illustrate the recent momentum of the euro area, we need only look at the composite PMI, which is back well above the 50 growth threshold at 54.10 after a trough at 47.30 in October 2022. Even though the euro area economy (barely) escaped negative growth in 4Q22, consensus expectations are still for a shallow dip of -0.2% in 1Q23. Tighter financial conditions and still-increasing core inflation are expected to dent household spending power and confidence.

#### Eurozone Composite PMI



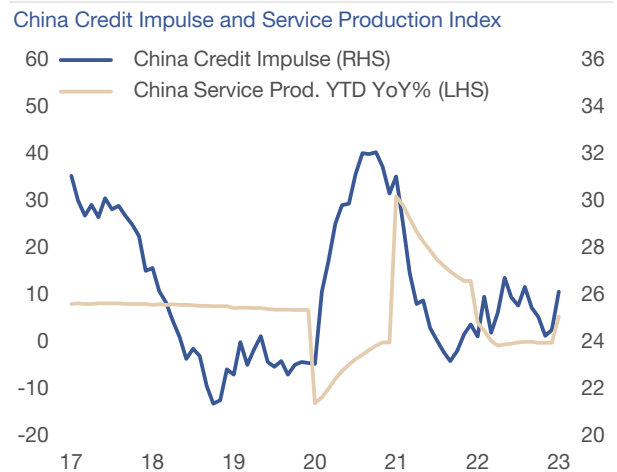
Euro area inflation peaked at 10.6% in October 2022, and the disinflationary forces since then have been mostly driven by the decline in energy prices. The story is different for core inflation, as we do not expect core CPI to decline before 3Q23 as services prices rise further, in part due to wage pressures. After spiking when Europe was battling the spread of Covid-19, the unemployment rate for the euro area has dropped sharply from 8.5% in August 2022 to 6.6% in January, and a GDP-weighted measure of the unemployment rate for the four largest economies of the EMU stands at its lowest since 1981. This tightness of the labor market is translating into larger pay gains throughout the bloc. The problem is that wage growth exhibits much more inertia in the euro area than in the US due to a greater share of employees who are part of collective wage agreements as well as multi-period wage agreements. As workers negotiate compensation for recent inflation, we see that the measure of compensation per employee has been increasing from 3.4% in 3Q21 to 5.8% in 4Q22. We expect this upward adjustment of wages to continue in the coming quarters, albeit at a moderate rate as the ECB's monetary tightening takes some of the heat out of the labor market.



The ECB proceeded with its interest normalization by hiking rates by 50 bps in March, in line with its determination to regain control of inflation. The statement gave no significant indications of the outlook for policy rates beyond March, simply emphasizing that a data-dependent approach will be taken. In terms of QT, the ECB stated that the decline will amount to €15 billion per month on average until the end of June 2023, and its subsequent pace will be determined over time. It is doubtless a good thing that the euro area economic outlook has improved markedly, but a more resilient economy means a hotter labor market, stronger wage pressures, and stickier inflation, all of which are expected to force the hand of the ECB to continue tightening monetary policy. Tightening lending standards due to the stress in the banking system is likely sparing the ECB one or two hikes, but in our view, the market pricing is still too dovish and will be adjusted. The outlook of the Eurozone economy thus depends now more than ever on the outlook of the ECB's monetary policy. We stick to our view that the terminal rate in the euro area will reach at least 4% before taking a pause.

### China Macro Outlook

China has decided to reverse its strict zero-Covid policies that hindered economic growth at the beginning of the year. The "China reopening" narrative has since gathered momentum, and we indeed see high-frequency mobility data normalizing fast. We also see that services are recovering strongly, as the monthly services production index was 5.5% year-on-year in February, from -0.1% in January. The property sector is also stabilizing, as indicated by the slowing momentum of the contraction in property investment in Q1. Moreover, home prices seem to have bottomed.



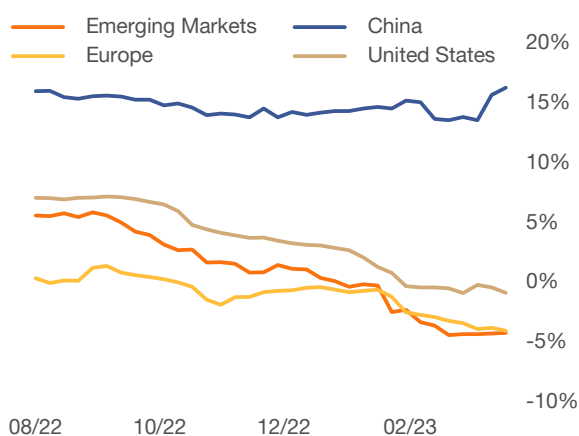
A few weeks ago, the National People's Congress set a modest growth target of 5%, but China's GDP overshoot the target after the previous two government reshuffles in 2012–13 and 2017–18. This time should be no different. Meanwhile, policymakers look set to adopt a pragmatic policy stance without major easing but with ad-hoc measures. All in all, the Chinese economy gathering momentum should help support the global economy. However, as the rebound is mainly driven by domestic services and less by imports, the boost for other economies, such as that of the euro area, should be more limited than in the past. Still, it will be the main driver of global GDP growth this year.

# Investment Outlook

## Equities

Developed market (DM) equities are facing strong macro headwinds as we expect the economic momentum of the US and the euro area to continue slowing down in the wake of tighter monetary policy starting to bite and the tightening of lending standards. This should translate into a decline of earnings this year; however, corporate earnings expectations do not reflect even a modest recession risk, as the expected EPS growth still stands at -1% for the US and at -4% for Europe. Earnings expectations have indeed come down markedly since the market peaked at the start of 2022, but we see the momentum of downward revisions fading.

### 2023e Earnings Growth



Even though the equity market typically troughs in the second half of a recession, we should not anchor our investment strategy on the recognition that a recession is underway. Indeed, historically, the National Bureau of Economic Research's (NBER) announcement of a recession has had an average lag of 8 months. As the average duration of a recession since 1960 is 12 months (excluding the 2-month Covid contraction), by the time officials declare a recession, the equity market might already have troughed. Since 1980, there have been 6 recessions in the US, and the average 1-year return of the S&P500 after the NBER recession announcement has been ca. 15%. This is why it is paramount to look at leading cyclical indicators and technical analysis.

Our technical analysis for DM equity markets leads to a more optimistic outlook than our macroeconomic research. There are more signals indicating that the low of the bear market was posted in October 2022 than indicating that we might break this low again. We have seen a bullish breakout above the downward-sloping trendline from the top and the 200-day moving average on many key indices, and we have seen several momentum and breadth "thrusts," which usually are seen at the beginning of a new impulsive upward move. From a pattern perspective, the recent price action of the S&P500, the Nasdaq100, and even the Russell2000 is quite constructive, albeit not yet outright bullish.

We prefer to opt for a defensive stance and favor quality, low-volatility, and high-dividend stocks. Cyclical and small-cap stocks are at greater risk in our macro outlook. As for the growth vs value debate, it will likely continue to be driven by the direction of yields. We can argue that mega-cap technology companies now have strong quality attributes given their sheer size, liquidity, and profitability. Hence, the Nasdaq100 could also fare well in such an environment. We also see pockets of opportunities in biotechnology and personal and household goods. Emerging market (EM) stocks should continue to benefit from the expected further weakening of the US dollar and the positive impact of China's reopening. The market is expecting EPS growth above 15% in China, and the trend of earnings revision has already turned positive. However, despite the appeal of Chinese stocks, we refrain from adding more at this stage given the high volatility and our already-overweight stance.

For now, it seems that the equity market is positioned for either a very mild and brief economic contraction or for Fed cuts, as it seems already to discount the recovery. In our view, DM equity markets are not accurately pricing the expected economic damage, as they still place too much faith in the Fed put. The risk is that they might be disappointed at some point and start to reprice a more hawkish Fed path, which will hurt risk assets. Due to the divergence between our macro and technical outlook, we maintain a neutral stance on equities, with a defensive tilt.

### Focus on China Tech

After spending nearly two years tumbling due to Beijing's crackdown erasing more than 80% of the sector value from peak to trough, we think China's internet stocks are finally on the mend and may be one of this year's most notable turnaround stories. China finally ended its zero-Covid policy recently, which will likely boost growth and foster more discretionary spending. Chinese internet companies are levered to the country's reopening story, as they have direct ties to Chinese consumers.

China's internet companies have also been taking the steps necessary to assuage Beijing, potentially significantly weakening regulatory headwinds for the year. A top Chinese official said recently that authorities would look to provide more support to tech companies and work toward making supervision of the tech sector more predictable going forward.

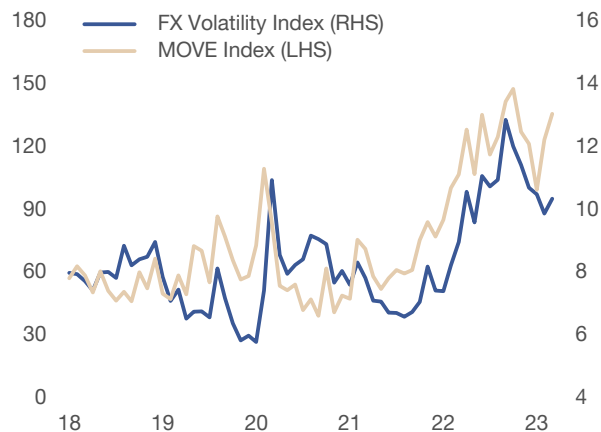
In terms of valuations, the sector trades at a significant discount relative to history and their US peers, despite the solid fundamentals. We believe that most of the price action in China's internet companies over the past years has not been fundamentally driven. Therefore, these companies present one of the most compelling long-term growth opportunities for investors today, even if they have a long way to go to recoup their previous glory.



## Rates

The outlook for US rates is complex in the current macro landscape. Rates uncertainties remain elevated, as highlighted by the heightened volatility in the US Treasury market (MOVE index), which recently surged back to levels reached during the 2008 global financial crisis. These uncertainties stem from the divergence between market expectations for future FFRs and the official Fed projections (the “dot plot”). Following the eruption of US banking problems, the pricing for the Fed path has strongly reversed, with market operators now expecting that the Fed is almost done and will start cutting rates as early as the second half of this year to reach 4.30% at the end of 2023. This is in stark contrast with the “dot plot” published by the Fed during its last meeting, which projects the FFR to be 5.15% at the end of the year. In our opinion, the Fed is unlikely to cut rates in 2023. We expect it to hike one or two more times into the summer and then remain on hold for some time before eventually starting to cut rates next year.

US Treasuries vs FX Volatility



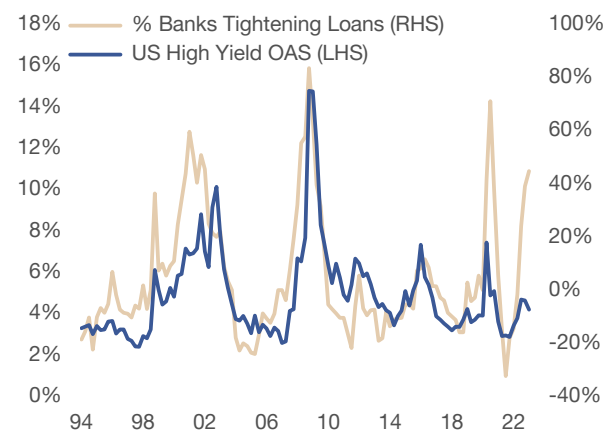
Short-end yields should move with monetary policy expectations, and we thus believe that the 2-year yield in the US could climb again during 2Q23. Things are admittedly more complicated for the outlook of the 10-year yield. From a theoretical point of view, we see yields rising as investors demand more compensation for holding them, given persistent and volatile inflation. Should core inflation continue to be elevated and sticky, it is also likely that inflation expectations will adjust upward, and that should translate to higher bond yields at longer tenors. That said, we expect the 10-year yield in the US to remain volatile and range-bound in the second quarter.

In the euro area, we see financial stability risks easing and the focus gradually shifting back to the sticky core inflation backdrop. In our view, there is scope for repricing higher of EUR front-end yields, given the huge amount of rate tightening that has been abruptly priced out recently. We remain shorter duration than the benchmark for the time being, but we plan to move closer to neutral duration as the ECB approaches the end of its tightening cycle.

## Credit

In our view, credit markets have remained resilient because of the over-abundance of faith that the Fed will soon cut rates to rescue the economy. We believe that credit spreads do not fully reflect the macro risks, and we see the decoupling with lending standards as a signal that there could be a catch-up in widening credit spreads. We thus remain underweight high yield (HY) both in the US and the eurozone, as we deem it still too early to become constructive on HY. Spreads have widened in recent weeks, but they are still not attractive enough on a long-term basis to represent an opportunity. Even if pockets of opportunities exist, higher financing costs, a softer economy, and low market liquidity will continue to exert pressures on the asset class.

High Yield Credit Spreads vs Banks Tightening Standards



We are more comfortable with investment-grade (IG) credit, as it should be more resistant to further widening of spreads, especially in the case of a material tightening in credit conditions, which would translate into the market pricing in a recession sooner rather than later. In addition, the current carry on IG debt is attractive enough to justify a neutral stance both in the US and in Europe.

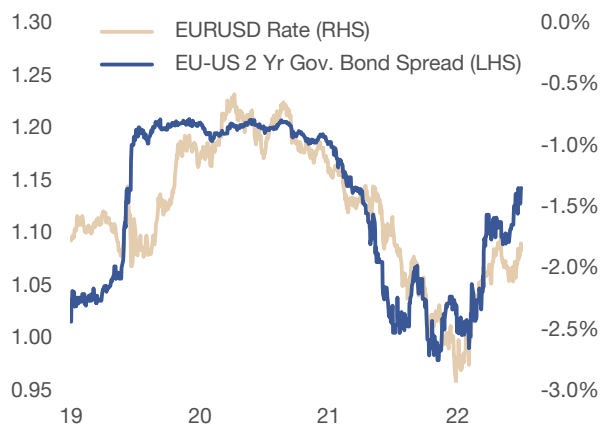
We find more value in emerging debt (EMD) compared to HY. Policymakers in large emerging economies have adopted stringent monetary policies to fight inflation and protect their currencies before their DM counterparties and now have ammunition for the future. A softer greenback should also be beneficial for the asset class. However, given the sensitivity of EMD to the ebb and flow of global risk sentiment, we refrain from adding at the asset class level and prefer to seize idiosyncratic opportunities across customized portfolios. We continue to perceive the need to be selective in order to avoid the most-leveraged issuers, who will face difficulties refinancing their debt loads

## Currencies

Quantitative models show that the pricing of relative monetary policy has been the main driver of the EURUSD in the past year. In this respect, we predict that the ECB will continue to hike even after the Fed reaches peak FFR. The trend of the differential should hence support EURUSD, with a possible break above 1.10 in the second quarter.

Gold recently broke above the key psychological \$2000 barrier and could well be heading towards the previous all-time high at \$2070. We would welcome a pullback below 1950 that would offer an attractive entry point. From a fundamental perspective, in the medium term, the likely peak of US real yields should help propel the yellow metal above its previous peak level.

EURUSD vs 2-year Differential



# Itemized Asset Allocation

	Less attractive	-----	Neutral	-----	More attractive
<b>Sovereign</b>		EUR Short & Mid Term	USD Long Term	USD Short & Mid Term	
	EUR Long Term				
<b>Investment Grade</b>		USD Long Term		USD Short & Mid Term	
		EUR Long Term		EUR Short & Mid Term	
<b>Other Fixed Income</b>		High Yield	Emerging Debt		
		Convertibles			
		Financial Subordinated			
<b>Equities</b>			United States	China	
			Europe	US Biotech	
			Emerging Markets	US Industrials	
<b>Alternative Investments</b>		Gold		Multi Assets	
				HF CTA	
				HF Global Macro	
<b>Currencies</b>			CHF		
				EUR	
		USD			

◀▶ Indicate the last change. Number of triangles indicates the movement amplitude

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**Geneva**  
Headquarter

CBH Bank  
Bd Emile-Jaques-Dalcroze 7  
P.O. Box  
1211 Geneva 3, CH

cbhbank.com  
t +41 22 839 01 00

**Zurich**  
Branch Office

CBH Bank  
Bahnhofstrasse 82  
P.O. Box 1213  
8021 Zurich, CH

cbhbank.com  
t +41 44 218 15 15

**Luxembourg**  
SICAV

1618 Investment Funds  
106, route d'Arlon  
8210 Mamer, L

1618am.com

**London**  
Subsidiary

CBH Wealth UK Limited  
2-4 Cork Street  
London W1S 3LG, UK

cbhbank.com  
t +44 207 647 1300

**Hong Kong**  
Subsidiary

CBH Asia Limited  
Suite 2001, 20th Floor,  
K11 Atelier, 18-24 Salisbury Road,  
Tsim Sha Tsui, Kowloon  
Hong Kong, HK

cbhbank.com  
t +852 2869 0801

**Nassau**  
Subsidiary

CBH Bahamas Ltd.  
CBH House, East Bay Street  
P.O. Box N-1724  
Nassau, N.P., Bahamas

cbhbank.com  
t +1 242 394 61 61

**Rio de Janeiro**  
Subsidiary

1618 Investimentos  
Av. Ataulfo de Paiva,  
204  
Leblon  
CEP: 22440-033  
Rio de Janeiro – Brazil

1618investimentos.com  
t +55 21 3993 6901

**São Paulo**  
1618 Investimentos Subsidiary

1618 Investimentos  
Rua Iguatemi, 192  
Itaim Bibi  
CEP: 01451-010  
São Paulo - Brazil

1618investimentos.com  
t +55 11 4550 4401

**Tel Aviv**  
Representative office

CBH Bank  
Rehov Tuval 40  
Ramat Gan  
5252247 Israel

cbhbank.com  
t +972 77 693 51 28



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**CBH** | Compagnie Bancaire Helvétique

Asset Management  
Boulevard Emile-Jaques-Dalcroze 7  
P.O.Box  
CH - 1211 Geneva 3

[am@cbhbank.com](mailto:am@cbhbank.com)  
[www.cbhbank.com](http://www.cbhbank.com)