Markets
& Convictions

May 2023

RJ Management

Stock markets are holding up despite the bank failures in the United States. Equity investors seem to be ignoring the increase in the cost of credit. The Fed has raised its benchmark interest rate, but a decrease is anticipated. However, wage inflation remains high, and unemployment is historically low. European monetary policy is lagging, and companies are experiencing slowing margins and growth. For now, consumers appear to be resisting inflation due to their accumulated savings since COVID. Nevertheless, we are convinced that a recession is inevitable in the United States and Europe. Alternative strategies and investments in energy and energy transition show promise. However, the equity allocation remains reduced.

Macro

- We have just witnessed three out of the five largest historical bank bankruptcies in the US. Yet the stock markets are holding up very well: (Year To Date performance) S&P500 +9.18% / Europe Stoxx600 +10.22% / SMI +7.74% / CSI300 +2.52%.
- For now, equity investors do not seem to pay particular attention to the negative effects of the rising cost of credit.
- In early May, the Fed raised its benchmark interest rate by +0.25% to 5.25% (for reference, we were at 0.25% in March 2022).
- The markets are already anticipating a decrease in this benchmark interest rate for September of this year, despite several statements from Fed members clearly not pointing in that direction.
- The job market is key to curb the negative inflationary spiral... Decrease in wage inflation will come through an increase in unemployment... However, we still observe the opposite with historically low unemployment rate at 3.4% and a strong job-creating economy.
- The European monetary policy is lagging behind... The latest increase brings its benchmark interest rate to 3.25%... And its president has been very clear: "We are not pausing – that is very clear."
- However, when asking manufacturing companies about their willingness to invest (ISM Manufacturing) or observing banks' willingness to lend to the economy, everything points towards an almost inevitable recession.
- This season of corporate earnings reports shows a relatively good performance, but both profit margins and revenue growth are slowing down.
- However, not as quickly as we may have anticipated. The consumer is still resisting inflation by using the savings accumulated during COVID and various government aids.
- The defeat of Russia in Ukraine seems to be getting closer day by day, but at what cost.
- China strategically positions itself in a new role as a "peace maker" by bringing Iran and Saudi Arabia back to the same table.

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Convictions

- The American (and Swiss) banking crisis is not an accident but the first step of a "classic" credit crisis where leveraged actors are affected.
- For years, banks have been buying US government bonds on their balance sheets with ridiculously low coupons and very long maturities.
- They did not have to value these holdings on their balance sheet and could deploy capital on riskier activities (such as financing Private Equity) against this asset of "excellent quality."
- With the rise in interest rates, the markets thought that banks would be able to increase their margin by earning additional returns.
- Technology and small investors have shown that they will not give this gift to banks... Depositors have massively invested in money market funds or treasury bonds to obtain 4%-5% yields rather than leaving their cash in accounts to receive "offered" 0.1%!
- In order to preserve their liquidity ratio in the face of this significant decrease in cash accounts, banks had to sell these "excellent quality" government bonds... but the rise in interest rates we just experienced caused their prices to plummet.
- As a result, the markets realize that the quality of these banks' balance sheets is not as solid, and panic sets in.
- However, we note that the 2009 crisis left a mark on regulators who are doing everything to ensure that depositors do not lose their savings. Clients of SVB / First Republic / CS, etc., have not lost anything... However, creditors and/or shareholders have been significantly impacted.
- We have taken profits on a large portion of our European Banks conviction (due to fears of contagion from the American banking crisis).
- Regarding inflation, we believe that the markets are too optimistic about future interest rate cuts (for reference, expectations are for USD rate cuts starting in September and early 2024 for EUR).
- Inflation generated by an exogenous shock (COVID and then the Ukrainian crisis) becomes a structural issue when inflation expectations become anchored in consumers' long-term outlook.
- This translates into wage inflation and a tight labor market, resulting in historically low unemployment rates in the US (3.4%), Europe (6.5%), and even France (7.1%!).
- In Germany, unions have just won a wage negotiation covering well over 2 million workers with an increase in wages exceeding +10% spread over 2 years.
- Therefore, our Fixed Income allocation remains very short and dynamic in cash management.
- Within a few years, China has become the largest buyer of oil from the Kingdom of Saudi Arabia, at the expense of the US (which has increased its domestic production).
- China's new diplomatic position will amplify the thesis of de-dollarization in our economies with the expansion of CNY as a new exchange currency (evidenced by Pakistan, for example).
- Historically, the loss of hegemonic position of a currency is a long process and always a period of instability, as described by Ray Dalio.
- In this environment, we are not surprised by the good performance of gold in our portfolio and are also confident in our positions in gold mining companies (consolidation beginning with Newmont & Newcrest).
- Our negative view on leveraged assets seems to be materializing, even on the largest Private Equity funds like Tiger Global.
- We are convinced that a recession is inevitable in the US and Europe.

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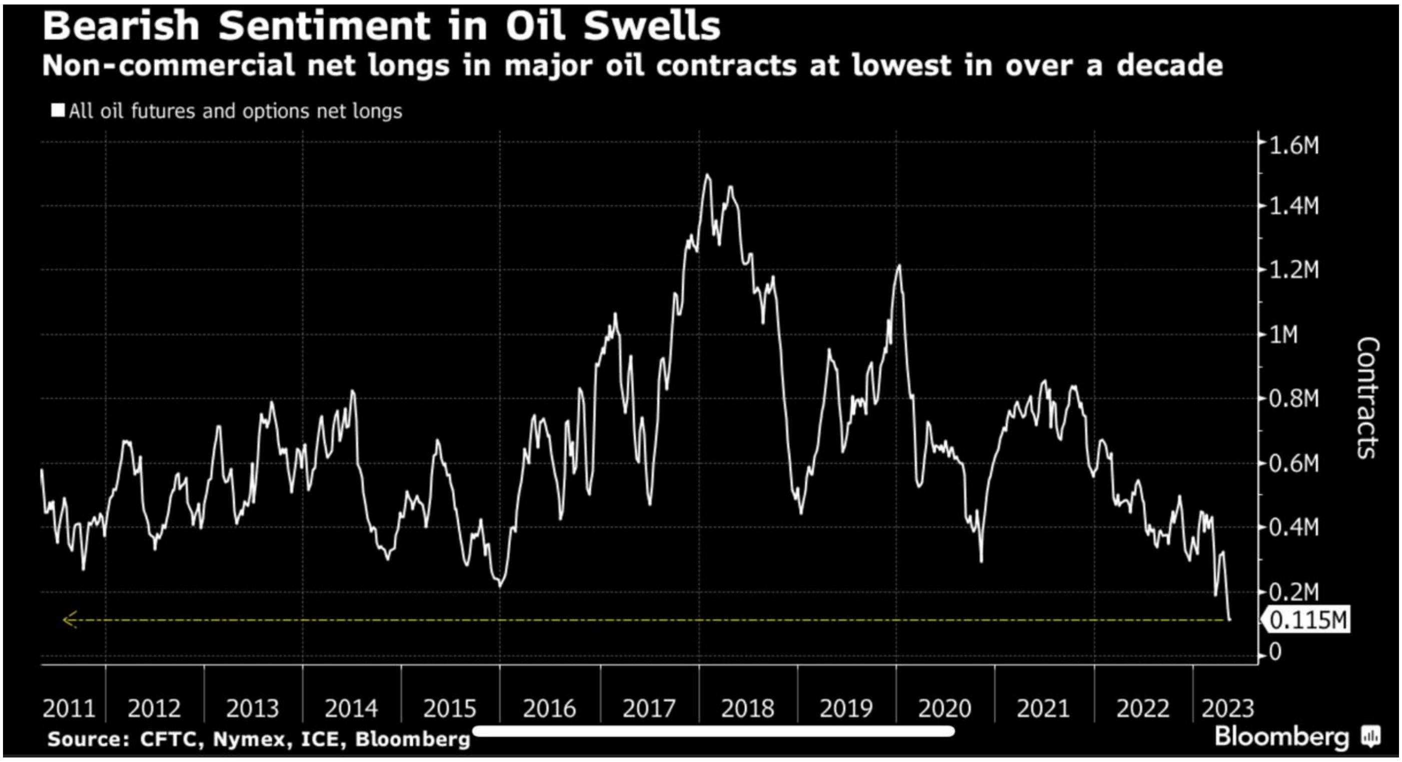
- Despite this, we remain very constructive on our energy theme (Westbeck) and energy transition (Volta) for structural reasons exacerbated by financial speculators shorting "like never before" (graph below).
- Alternative strategies such as long-short (like Invenomic or Eleva Absolute Return) will be a significant source of performance in the coming years.
- Our equity allocation is reduced (+/- 25%) with a mid and small-cap positioning that suffered last year but offers an interesting rebound this year with three different and complementary vehicles (Berenberg European Small Cap - Sturdza Strategic European Silver Stars - GAM Swiss Small & Mid).

Chart of the Month: Speculators' positions on oil futures contracts



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