Research
Crèdit Andorrà Financial Group

Fourth quarter 2022

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INDEX

Quarterly Report

Our view on the markets

Fishing in troubled waters

Inflation and corporate earnings developments are the two compasses that should guide us in navigating the markets over the coming months.

And the path they point to is not exactly smooth. Inflation should be harder to tame in the US than in Europe; wages grow much more across the pond, while temporary factors such as price hikes are more important in Europe. In both cases, a hard line will be required from the monetary authorities. The ECB, is following in the footsteps of the Fed, which is much more hawkish—as it must and can be (the economy is much more robust). It is hard to believe that such a tightening of financial conditions will not lead to a recession, which in the eurozone seemed inevitable anyway. We must also assume that the safety net that central banks have placed under the markets these past decades is no longer there, or is much lower. They will not come to the rescue, as they once used to, when the losses pile up. Their main struggle is now inflation, and they cannot afford to rest while it remains at stratospheric levels.

An environment of stubbornly high inflation, with a recession that seems imminent and inevitable, and where the superhero of the markets (central banks) is weighed down by a kryptonite necklace (inflation), is not exactly the sort of wish list one would write. Right? Think again.

For the patient investor (remember these words), whose objective is to maximise savings over the long term, the environment we came from was certainly not the best. In fixed income, decades of price increases disguised a coupon declining to absurd levels (until "yielding" negative interest rates!). We must not forget that this coupon should be the main attribute of the most conservative part of a portfolio: we aspire to receive a recurrent income stream, without diminishing the capital we contribute to it. In perspective, we are much better off now, as we finally seem to be able to make a return on our savings, something that has been lacking in recent years. For the equity investor, over-enthusiasm tends to be matched by over-pricing. But also, from time to time, the mood shifts to panic, which leads to rock-bottom prices. We think we come from the former and are headed towards the latter scenario. A patient investor (again) should prefer this second environment for building the portfolio to pay for occasional indulgences or needs far off in the future. Surely, good prices will lead to better returns in the medium term.

Those two words, "investor" and "patient", ought to distinguish those who should be concerned about their savings today from those who should not. Those seeking short-term benefits do not invest, they speculate (absolutely nobody knows for sure what will happen tomorrow). And patience, according to Warren Buffet, is the main attribute of anyone wanting to grow capital successfully. There must be a reason for that.

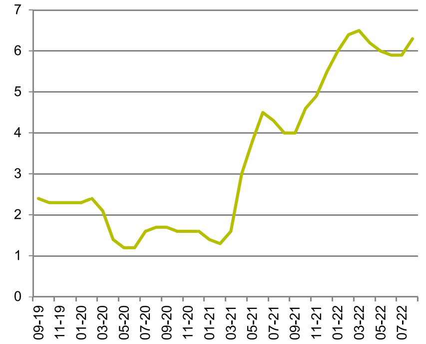
David Macià, CFA
CAAM Investment Director

Strategy

Asset allocation (2022 Q4)	
Monetary	↑
Fixed Income	→
Equities	↓
Fixed Income	
GOVERNMENT	
USA	→
Eurozone	→
INVESTMENT GRADE	
USA	→
Eurozone	→
HIGH YIELD	
USA	→
Eurozone	→
EMERGING MARKETS	→
Equities	
USA	→
Eurozone	→
Japan	↑
Emerging Markets	→
Commodities	
Oil	→
Gold	→
Currencies	
EUR/USD	→
JPY/USD	→

Macroeconomic View

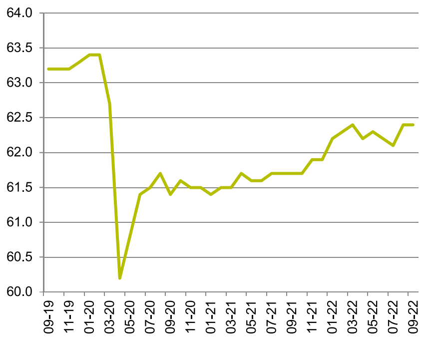
US CPI less food & energy



Source: Bloomberg

Core CPI (excluding food and energy) accelerated to 6.3% year on year from 5.9%.

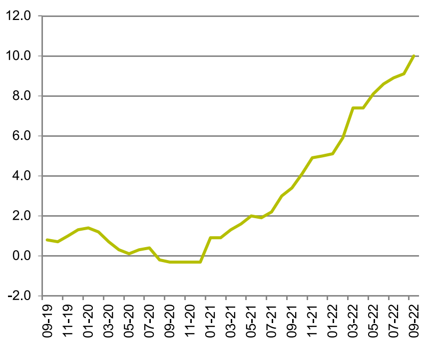
US labor force participation rate



Source: Bloomberg

Although the participation rate has been recovering, it is still a full percentage point below pre-pandemic levels.

Euro zone CPI



Source: Bloomberg

In the eurozone, inflation is at an all-time high.

The global economic outlook worsens

Inflation has continued to surprise to the upside with price pressures broadening across categories. In turn, higher than expected inflation has reinforced central banks' commitment to restrictive monetary policies and, as countries worldwide simultaneously hike interest rates, the probability of a global recession rises.

US inflation surprised to the upside with core CPI (excluding food and energy) accelerating to 6.3% year on year from 5.9%. The strength in core inflation was led by the service sector, where inflation is typically led by wage inflation. That should not be a surprise given the ongoing tightness in the US labour market. Although job growth has slowed and the unemployment rate has ticked up, absolute growth is still strong and average hourly earnings growth has been above 5% since the beginning of this year. The labour market remains fundamentally unbalanced, with significantly greater demand for labour than available supply. Currently, there are around 6 million unemployed but over 10 million job openings, according to the latest JOLTS (Job Openings and Labor Turnover Survey) data. Although the participation rate (share of the population over the age of 16 working or actively seeking work) has been recovering, it is still a full percentage point (or 1.6 million people) below pre-pandemic levels, which explains the tightness of the labour market.

The strength in the labour market has obliged the Fed to act more forcefully, clearly stating that the fight against inflation will not be without pain, and so suggesting a higher probability of a recession.

> The fact is the Fed needs to see an increase in unemployment and a decrease in demand to be able to tame inflation

In the eurozone, not only is inflation at an all-time high and the ECB in a hiking cycle, but the region is also facing one of the worst energy crises in history. Without a ceasefire in sight, there seems to be no easy answer to the energy crisis. Indeed, the Russian annexation of four Ukrainian regions, the sabotage of the Nord Stream 1 & 2 pipelines and new sanctions all point to an escalation of the conflict. If Russian gas supplies to Europe remain cut off for a long period, companies would likely be forced to curb gas-intensive activities, followed by supply chain disruptions, leading to a deeper eurozone-wide recession. More time is needed to find alternatives to Russian gas and oil. Although Europe is investing in alternative energies and building LNG infrastructure to import more gas from other regions, the lag before new capacity is available means near-term economic pressures cannot be avoided. The European Union has been filling up its gas storage quicker than expected, but it will be insufficient to meet winter demand. Rising negative consumer sentiment is yet another risk factor amid the rising cost of living. The European Commission has announced a package of proposed emergency measures, including a windfall profit levy on energy firms, liquidity support for power companies and fiscal measures to try and soften the blow for consumers in many countries. However, these measures will probably not succeed in avoiding a recession.

How the economy evolves from here very much depends on where inflation is headed and how quickly a tightening of financial conditions can bring demand back in line with supply as the labour market adjusts. In Europe, the conflict poses a further constraint. As always, central banks are faced with a difficult balancing act but this time, they have made it quite clear that their priority is taming inflation even if it means foregoing economic growth.

Jadwiga Kitovitz, CFA
Head of Multi-Asset Management and Institutional Accounts

Fixed Income

Looking for the peak

The new financial market season kicked off with the traditional central bankers meeting in Jackson Hole at the end of August, and Fed Chair Jerome Powell reiterated his tough stance on inflation, prompting market fears of a hard landing by raising interest rates more aggressively.

Central banks, determined to tame inflation and avoid the mistakes of the 1970s, will hike interest rates to the extent necessary to curb demand and regardless of the possible impact on economic growth, even if this leads to a recession. The bullish shift in the monetary policy cycle is evidenced by continued rate hikes. Over 40 central banks have increased reference rates by at least 0.75% in a single jumbo hike, and Sweden's Riksbank hiked them by 100 bp at its last meeting.

If central banks are expected to hit the peak of hikes, this will imply a reduction in interest rate volatility

They say it is not the bullet that kills you but the speed, and central banks have never before moved so quickly in raising rates. This has been the main factor behind the massive sell-off in fixed income, ending the four-decade long bull market—probably a necessary correction after a period of ultra-low yields that have proved unsustainable. This historic development, with major global fixed income indices declining by 12–20% this year, leaves a more favourable backdrop for considering investment in this asset class. Surely, rising yields are an opportunity to add duration as inflation peaks and growth slows.

One of the advantages of fixed income is that we know in advance the return on the investment if we hold it to maturity, irrespective of market movements in the period, and barring a credit event. This means we can now see that it is possible to invest in various types of bonds with a return that offsets the inflation expected by the ECB (5.5% in 2023 and 2.3% in 2024), and which allows us to maintain the purchasing power of money and generate some profits.

The next meetings of the ECB and the Federal Reserve will take place in late October and early November respectively. Interest rates are expected to rise further and implied rates stand at 2.5% for the ECB and 4.5% for the Fed at the beginning of October, suggesting still a +1.25% rise in both cases before these meetings. Meanwhile, the RBA (Reserve Bank of Australia) delivered a modest surprise in its latest decision by raising its benchmark rate by 25 bp, less than expected, fuelling the debate that central banks are approaching their benchmark rate peaks. Investors expect central banks to get their decisions right and avoid policy mistakes, and thus minimise the impact on the economy by piloting a soft landing.

Until we see more evidence of central banks reaching the terminal rate (better inflation expectations would certainly help), interest rate volatility will not be reduced and spreads and prices will not normalise. A shift in focus from inflation to growth would also be important for this asset class, as in the event of an economic downturn, fixed income assets would serve as a source of diversification with inflows supporting prices.

In this environment, where bonds are starting to offer interesting yields that have not been seen for a decade, and which increasingly protect against price variations, the strategy is to build a portfolio gradually. We want to avoid those issuers most vulnerable to increasing financing costs and with the aim of increasing the overall yield of the portfolio, thus being able to recover what has been lost this year with the minimum time horizon.

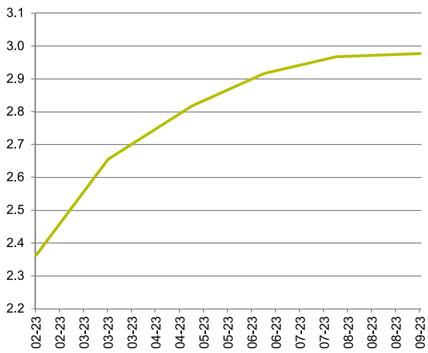
Josep Maria Pon, CIIA
Head of Fixed Income and Monetary Assets

Bloomberg EuroAgg Index

Source: Bloomberg

Bloomberg EuroAgg index yield-to-maturity performance at levels not seen in a decade.

ECB

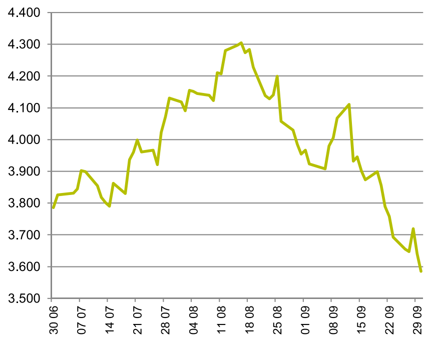


Source: Bloomberg

The ECB's implied rates currently discount a terminal rate of around 2.5% in March 2023.

Equities

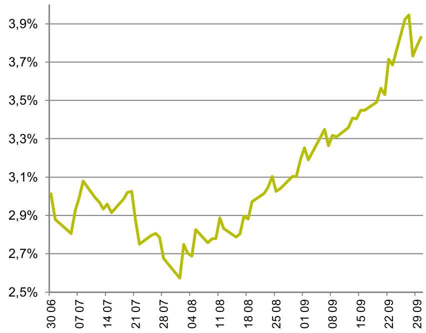
S&P 500 2022 YTD



Source: Bloomberg

The S&P 500 has returned to the lows we saw in June.

Yield of US 10 year Treasury



Source: Bloomberg

Will 4% be the peak?

Higher rates and lower earnings

The environment for stocks has gotten more challenging with the Fed's rate hikes and suggestion that there are more rate hikes to come. It has also gotten more competitive for stocks because the yield that had been missing in the Treasury market during an abnormal period of rock-bottom interest rates has been found again.

In our previous newsletter, we commented on how the S&P 500 had its worst first half of the year since 1970, falling by over 20%. The third quarter brought us more of the same with the S&P 500 losing 5.3% while interest rates went up and corporate earnings estimates went down.

Market rates have moved up appreciably this year. The 2-yr Treasury yield, which started the year at 0.73%, ended the third quarter at 4.17%. The 10-yr note yield, which started the year at 1.51%, is at 3.75%. This stands in sharp contrast to the dividend yield of the S&P 500 which stands at a comparatively unimpressive 1.8%. Even with the sharp decline in the stock market, the dividend yield on the S&P 500 is more than 200 basis points below the yield of the 2-year Treasury.

> "I think Powell should offer the American people an apology for such poor monetary policy", Jeremy Siegel

Normally, the 10-yr would be yielding more than the 2-yr, but we are not in a normal time. Things have gotten abnormal because high inflation has necessitated a normalization of monetary policy. The worry for the market is that the Fed's rush to normalization will go too far and invite a material economic slowdown, if not an actual recession. Hence, the 2-yr note and the 10-yr note are inverted with the former yielding more than the latter.

Treasuries having a significant yield again is good news for fixed-income investors. It is also good news for investors looking for more balance in their investment portfolios, but it is not good news for the stock market. This is because a higher risk-free rate lowers the present value of future cash flows, making stocks (especially high growth stocks) worth less. This has been a key driver of the multiple compression the S&P 500 has suffered through this year. When this year began, the forward earnings multiple for the S&P 500 stood at 21.2x and by the end of the third quarter, it had compressed all the way down to 15.4x. Lower stock valuations create better long-term return opportunities for investment and the current multiple is below the 10-year average of 17x. While this could be an attractive entry point into the market we must consider that forward earnings estimates are likely to still be too high. Wall Street analysts project earnings growth to be 8% in 2023. That level of earnings growth seems to be particularly sanguine when many economists forecast the US economy to experience a recession during 2023.

The earnings growth number for 2023 is likely to come down, meaning that today's market multiple is not the true value it appears to be. If this is the case, better entry points will avail themselves when earnings estimates come down further to reflect the tougher economic environment that lies ahead. This process may begin to play itself out during the third quarter earnings season. Analysts have already taken a hatchet to third quarter earnings estimates, but the key to begin to take down earnings estimates for the next year will be the guidance given by the companies. The estimated earnings growth rate for the third quarter was 9.8% on June 30. Today it sits at a paltry 2.3% meaning that the third quarter earnings bar has been lowered significantly. However, weak guides from market-moving companies may be painful in the short-term but will be part of the process to create a better set-up for investing over the long-term.

Charles Castillo
Senior Portfolio Manager

Commodities and Currencies

COMMODITIES

Game changer

The rules of the game have changed. When the European embargo on Russian oil comes into effect, Russian production will fall due to difficulties in releasing all those barrels: market tension will rise.

It is likely that Russian exports will continue to decrease considerably: the US, South Korea and Japan have reduced their imports of Russian oil from 1 million barrels a day to almost zero in just a few months. However, this has not been the case with the European Union, which continues importing over 3 million barrels a day. At this stage, it is highly doubtful that India, Turkey and China, which have increased imports of Russian oil by just over 1 million barrels per day, are able or willing to increase their imports further. As a result, once the EU's import embargo begins, Russian exports will have few alternative avenues.

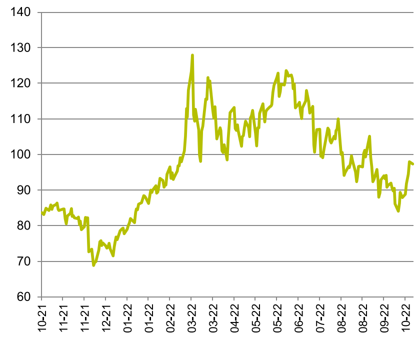
On the other hand, the price of oil has recently fallen to around 85 dollars from 120 dollars three months ago, due among other things to fears of a global economic recession, rising interest rates in the US and the strength of the dollar. The market seems to want to anticipate a sharp slowdown in oil demand.

As a result, it is not surprising that OPEC+ agreed to a production cut at its last meeting. OPEC+, which includes Saudi Arabia and Russia, surprised the market by proposing production cuts of 2 million barrels per day, the largest output cut since the pandemic. They admit they want oil to be above $90.

Such a decision is fundamentally difficult to justify, as the oil market is suffering from anything but a surplus, but apparently some oil-producing country wants to exploit its power and increase tension in oil-consuming countries.

Miguel Ángel Rico, CAIA
Investment analyst

Brent Oil



Source: Bloomberg

Oil between tight supply and lower demand.

CURRENCIES

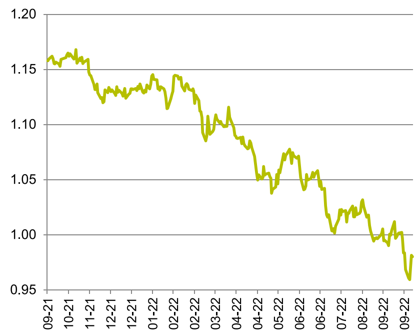
An exceptionally strong dollar

One of the few assets with gains year to date is the dollar. The greenback has reached multi-decade highs against most developed countries' currencies and several emerging currencies as well. The US dollar has been exceptionally strong, and it is difficult to pinpoint what could change in the near term to pull it down. The Federal Reserve has hiked more aggressively than other major central banks and, while the US economy remains relatively resilient, the Fed has the means to continue to raise rates further and faster, thus expanding the US interest rate advantage. Moreover, the euro is likely to remain volatile and under pressure until we see either ceasefire talks or signs that Europe has secured sufficient alternative energy supplies. Germany has recently announced plans for a fifth Floating Regasification Unit, allowing it to import more liquefied natural gas from around the world. However, the lag before new capacity is available means near-term economic pressure from the energy crisis cannot be prevented.

The dollar will probably only start to weaken once the peak in US rates is more clearly in sight or if we start to see inflation come down significantly, which would be a forerunner of the former. Indeed, the Fed will want to see evidence of a cooling in inflation and the labour market before signalling a pivot in its monetary policy. Finally, the dollar will continue to benefit from its haven status if geopolitical tensions worsen, be it an escalation of the war in Ukraine or rising frictions between the US and China, or if we continue to see high volatility in the markets. At these levels, the greenback seems very expensive, but it could stay strong for some time.

Jadwiga Kitovitz, CFA
Head of Multi-Asset Management and Institutional Accounts

Euro dollar exchange rate

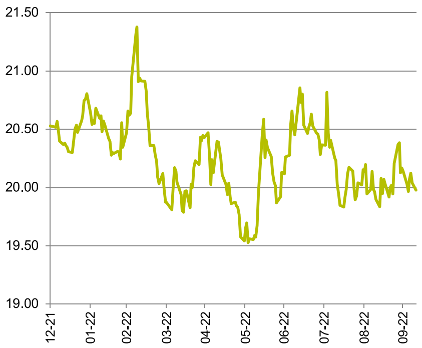


Source: Bloomberg

The dollar has risen 14% year to date against the euro.

Latin America

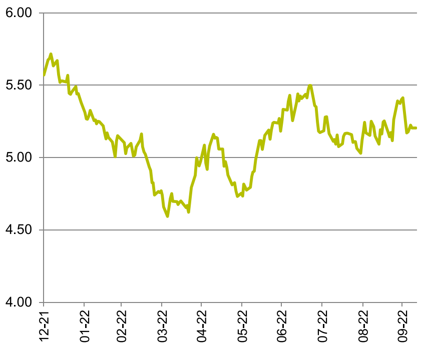
USD/MXN



Source: Bloomberg

The Mexican peso has appreciated 2% against the dollar sice the beginning of the year.

USD/BRL



Source: Bloomberg

The Brazilian real has appreciated 7% against the dollar sice the beginning of the year.

Between economics and politics

Brazil and Mexico, the region's leading economies, are seeing their currencies vying with a strong US dollar and positive real interest rates.

The dollar at its highest level in 20 years is, as usual, taking its toll on emerging countries. Firstly, those with a high level of dollar debt have seen their financing costs rise sharply. Second, net energy and food importing nations, in many cases, have to pay in dollars for their supplies in the midst of a global supply crisis. As a result, these countries have had to make massive use of their foreign currency reserves, especially in dollars. According to the International Monetary Fund, such a pace of reserve sales has not been seen since 2008.

The pace of decline in international reserves is the fastest since 2008

However, Latin America's two largest economies, Brazil and Mexico, are escaping this situation. The Brazilian real has appreciated by nearly 7% against the dollar so far this year, while the Mexican peso has appreciated by 2% at the time of writing. There are several reasons for this.

First, both countries, along with others in the region, led the way globally in raising interest rates to tackle inflation. Their central banks are adept at dealing with price pressures and are used to living with high rates. As a result, both countries now have positive real rates. Both had an annual inflation rate of 8.7% at its most recent count, while their benchmark rates are 13.75% for Brazil and 9.25% for Mexico. Quite unlike many of their emerging peers, let alone some developed countries, where real rates are in deep negative territory. Despite the usual political instability in the region and the rise of populism, the region's central banks have managed to retain some independence and stability. In Peru, for example, the central bank governor has held his post for 16 years, surviving five presidents of different political persuasions.

Mexico, which has one of the most liquid currencies globally, receives huge amounts of dollars in remittances from workers living in the US. These grew by 20% in the last 12 months. It is also less dependent on foreign raw materials than its regional neighbours.

Brazil, on the other hand, has seen its agricultural and energy exports rise sharply, with prices particularly high due to the war in Ukraine. Petrobras, a semi-state oil company, posted record profits last quarter, paid out $17 billion in dividends and supplied the state coffers with some $6.2 billion. The company, the goose that lays the government's golden eggs, is likely to be the target for control by whichever of the two candidates wins the second round of the presidential elections on 30 October. In the first round, former president Lula da Silva beat incumbent Jair Bolsonaro, albeit by a smaller margin than the polls indicated. Lula, who has a five-point lead in the first round results, lived through the commodities boom during his term in office, but investors are sceptical of his economic programme, which focuses on the state as the driver of growth. Bolsonaro, on the other hand, led ambitious fiscal and pension reforms, and is more in favour of privatisation and free markets, although he has not hesitated to use his power to influence Petrobras and other state-owned companies. The market is prepared for any outcome, but will closely monitor the evolution of Brazil's public finances to see if it continues to believe in the country's potential.

Juan Gestoso Ruiz
Investment analyst

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Research

Crèdit Andorrà Financial Group