FFG

FORUM FINANCE

1994

INVESTMENT PERSPECTIVES 2023

JULY 2023

TABLE OF CONTENTS

EXECUTIVE SUMMARY 1

2023 – HALF-YEAR: REVIEW OF OUR INVESTMENT THEMES 2

1H23: ECONOMIC AND POLITICAL DEVELOPMENTS 4

FIRST HALF 2023: FINANCIAL MARKETS 8

FIXED INCOME 8
EMERGING MARKET DEBT 10
EQUITIES 10
COMMODITIES – OIL AND INDUSTRIAL METALS 12
COMMODITIES – GOLD 12
CURRENCIES 13
HEDGE FUNDS 13

SECOND-HALF 2023: ECONOMIC OUTLOOK 15

ASSET CLASS VIEWS – 2H23 - JUNE 2023 18

MAIN ASSET CLASSES 18
FIXED INCOME 18
EQUITIES 19
COMMODITIES - GOLD 22
HEDGE FUNDS 22
CURRENCIES 23

SECOND-HALF 2023: INVESTMENT IMPLICATIONS – JULY ASSET ALLOCATION 24

CASH 24
FIXED INCOME 24
EQUITIES – UNDERWEIGHT CONFIRMED 25
COMMODITIES – GOLD: CUT TO NEUTRAL 26
HEDGE FUNDS: RETAIN OVERWEIGHT VIEWS 27
CURRENCIES 27

ASSET ALLOCATION GRID 28

EXECUTIVE SUMMARY

Risky assets thrived

After a tough 2022 for equity and fixed income assets, triggered by the rapid pace and magnitude of the hiking cycle initiated by the Fed and ECB, the first half of 2023 offered a relief with strong return of financial assets despite uninspiring level of economic activity in Germany and China. The Government and Investment Grade bonds had a reasonable start to the year while commodities suffered from economic growth concerns. Equity indices posted strong results, but return differences across sectors and stocks were particularly notable. The dispersion within equity markets became particularly accentuated during the second quarter after the markets had given back most of their initial strong performance at the start of the year due to the collapse of a few banks in February and March, reiterating the nasty bite fast rising rates can have on corporate balance sheets.

Narrow equity market participation

Concentrated portfolios exposed primarily to large technology stocks were rewarded. Only a handful of tech shares have been responsible for most of this year’s gains despite higher rates. Indeed, the seven-largest companies in the S&P 500, all tech companies, are up 86% on average year to date!! Meanwhile, the other 493 companies, in aggregate, have barely moved this year. In Europe, technology companies ASML and SAP have been joined by LVMH and L’Oréal as key contributors to the market surge explaining more than 40% of the index return.

U.S. growth resilient, Germany in recession

Early June, the World Bank revised its forecast for US growth for 2023 to 1.1% from 0.5% in January while China’s growth is expected to climb to 5.6%, compared to a 4.3% in January. The modest rebound in activity in China will primarily benefit domestic sectors, in particular services. Euro area GDP growth is now expected at 1.1% and 1.6% in 2023 and 2024 respectively. The key positive change underpinning this revision is the fall in energy prices and abating supply-chain disruptions.

Hawkish tone reiterated by the FED and ECB

The persistence of core inflation has emerged as a key risk as it could lead to more monetary tightening. However, lower energy prices have reduced headline inflation, with positive effects on demand and financial markets. The FED decided to hold rates unchanged in June, but most members agreed that at least one additional 25 basis points (bps) hike will be required by year end. In June, the ECB raised its deposit facility rate by 25 basis points (bps) to 3.5% and made it clear that further rate hikes should be expected at the next meeting in July, while in Japan the Bank of Japan remained dovish and will continue to support the fragile economic recovery despite stronger-than-expected inflation.

Commodities weak again

Commodity index recorded negative returns in Q1 and Q2, making it the worst asset class in our investment universe with -5.0% and -2.5% respectively as energy prices fell as global growth slowed, energy conservation and mild weather helped reducing energy demand, while rapid expansion of LNG capacities mitigated pressures in natural gas market. Prices of base metals eased due to weaker global demand in particular the slower-than-expected demand rebound in China. Additionally, increased metal supply has put additional pressure on prices. In precious metals, gold delivered a positive return (+5.23% in 1H).

Too few equities in risk-on

Our defensive allocation throughout 1H favoured alternative investments such as hedge funds for their ability to seize opportunities in periods of high volatility and to limit drawdowns and gold, which performs reasonably well in periods of stress and inflation.
We maintain our relatively defensive allocation with a preference for alternatives at the expense of equities. Our allocation remains well diversified, which should benefit from some inevitable mean-reversion or provide some protection if markets take a turn for the worse.

.

2023 – HALF-YEAR: REVIEW OF OUR INVESTMENT THEMES

Too defensive reduced short-term upside capture

Our central scenario was lately too cautious on the global growth as we thought that central banks hiking cycle would materially slowdown developed economies with the risk of deep recession if inflation were not contained.

Contrary to last year, where defensive characteristics were rewarded as it helped to mitigate the negative impact of the fast-paced tightening cycle initiated by major central banks in response to the surge in inflation on traditional asset classes such as bonds and equities, this year was a more risk-on market, particularly in 2Q, with huge return disparity.

In descending order of performance: technology-heavy Nasdaq Index posted its best first half (1H) in 40 years; U.S. large cap index outpaced the US Aggregate bond Index by 1'500 basis points in the first half, its fourth best since 1990 and finally; commodities measured by the S&P GSCI Index was the worst asset class in 2Q and year-to-date.

Too few equities in risk-on 2Q

Our rather defensive allocation throughout 1H favoured alternative investments such as hedge funds for their ability to seize investment opportunities in period of high volatility and to limit drawdowns and gold, which perform reasonably well in period of stress and inflation.

The gradual market anticipation of a more benign economic downturn combined with interest rates getting closer to the terminal rate have fuelled the equity rally far beyond our most optimistic expectations. Hence, our underweight stance in developed equites has been proved particularly costly in terms of relative performance in 2Q and particularly during the June rally.

Alpha strategies lagging in technology led rally

Our assessment of the risks associated with economy and monetary policy led us to favour strategies that strive well during risk-off periods such as hedge funds and more specifically macro strategies. This overweight position helped our performance in 2022 but was detrimental to our performance as it was partially financed by our underweight in public equities.

Our Global Macro exposure suffered a setback in June, as one manager, who had a bearish positioning (long bond – net short equity) was taken off guards by the strong June equity rally giving up most of his gains for the year. Event-Driven strategies, which often focus on out-of-favour equity exposures and speculation on M&A situations posted negative returns of -2.9% in 2023. Only strategies with higher beta to equities such as Risk Parity outperformed more divergent strategies.

Disappointments of Emerging and Frontier

Our constructive view on emerging markets was increased with a dedicated allocation to China as we expected a stronger recovery after the COVID lockdown measures were removed. This positive bias toward emerging markets came at the expense of US stocks, as their valuation appeared quite demanding and to a lesser extent European shares due to the higher geopolitical risks and tensions caused by the Ukraine conflict.

Our decision to overweight emerging and frontier markets detracted to performance as emerging markets, in particular Chinese stocks, delivered mediocre returns particularly in the second quarter. Indeed, global emerging markets delivered little less than 1% in 2Q after an increase of 4.4% in 1Q bringing the half year performance to 4.9% in U.S. Dollar. In the case of frontier markets the picture is not much better with 3.2% in 1Q, 2.1% in 2Q and 5.3% in U.S. Dollar half-year-to-date but our frontier market manager delivered strong performance with a 13.5% increase.

Owned technology but not enough

Technology stocks in the US and Europe fuelled the surge of market indices, such as the S&P 500, Nasdaq and, to a lesser extent, the Euro Stoxx 50.

Notwithstanding our direct exposure in technology stocks in our thematic bucket and the ones held in regional strategies, we were obviously not sufficiently exposed to the sector to seize the full price surge of some of the largest technology stocks.

By comparison, markets such as the UK that have more limited exposure to the Artificial Intelligence mania, turned out to be a lot less vibrant. Indeed, energy stocks like BP or Shell lagged, as oil and gas prices corrected after an extraordinary 2022 while diversified metal miners such as BHP and Rio Tinto struggled as China's economic recovery softened.

Diversifiers failed to cope with equities

At the beginning of 2023, uncertainty over inflation, labour markets and health of banks to list but a few made our forecast subject to a wide range of outcomes (risks). Hence, after the most rapid and aggressive tightening monetary policy for more than 40 years, we expected financial and economic stresses to emerge sooner rather than later.

We kept our overweight allocation to hedge funds such as systematic global macro, long/short equity and CTA in order to make our portfolios more resilient to shocks. Even if fully rational, our diversification in these strategies away from equities has been detrimental to our relative performance especially in 2Q as it limited our participation to the equity rally.

Our gold position delivered a robust return in 1Q but gave up some of these gains in 2Q to finish 1H up 5.23%, a return equivalent to US High Yield.

Huge return disparity

In the US, sectors such as Technology, Communication Services and Consumer Discretionary are all up more than 30% on the year. Without them, the S&P would be flat in 2023! Big tech dominated 1H while sectors like Energy, Utilities, Health Care and Consumer Staples are all in negative territory for the year. Our thematic equity bucket benefited from our investment in a technology focussed strategy but lagged overall due to our exposure to specialist strategies such as Medtech and biotech, Mining and Infrastructure stocks.

Tighter spread supported Credit (IG + HY)

The steady increase of interest rates across the curve during the second quarter caused some losses on long maturities while higher yielding securities, such as Investment Grade (IG) or High Yield (HY) corporates benefited from high coupons, tighter spreads, and lower interest sensitivity.

Due to our prudent assessment of global growth, we remained sceptical about central banks' chances to bring inflation back on target and that volatility would provide ample opportunities to increase our allocation to long-dated bonds.

We kept an underweight exposure to government bonds and favoured flexible strategies that can adjust their portfolio exposures as opportunities arise. We have gradually increased our exposure in high quality bonds with longer maturities, but our limited exposure to interest rates in favour of credit has mitigated the negative effect of higher interest rates in developed economies caused by fears of inflation experienced in February and May.

1H23: ECONOMIC AND POLITICAL DEVELOPMENTS

Global growth: higher in 2023, lower in 2024

The past six months turned out to be a better for economies than initially anticipated. The latest forecasts expect a global growth of 2.4% in 2023 from 2.0% thanks to better US growth.

Previously forecasted at 2.2% for 2024, growth is now expected to slow and forecast at 1.9% because the US economy will be hit by recession towards the end of the year.

The US economy has showed resilience thanks to a strong labour market. However, higher interest rates, currently above 5% has increased borrowing cost in particular mortgage rates. These higher costs will reduce consumer's spending ability and will curtail economic growth.

While manufacturing has suffered from weaker demand and soaring costs, the service sector has shown some resilience with a robust level of activity thanks to the combination of a remarkably strong labour market and extra-savings accumulated during COVID that have more than compensated the negative impact of higher costs and interest rates.

In Europe, the Eurozone PMIs composite slowed in June falling to 49.9 from 52.8 in May. The manufacturing PMI has been in contraction territory and showed additional weakness. The highlight came from the slowdown in services reinforcing the risk of a severe downturn ahead.

The UK economy should be able to avoid technical recession, but growth will stagnate this year before picking up to a 0.9% growth level in 2024.

As a major exporter of manufactured goods, the weaker global manufacturing demand is weighing on the Chinese economy. Another headwind is likely to persist: the housing market. The recent housing starts, and sales have shown signs of weakness, but the risk of a China's housing crash is limited as lenders are majority state-owned and therefore will not default.

Headline Inflation declining but "sticky inflation" persists

In 2022, US inflation reached its highest level since 1981. A global phenomenon caused by strong consumer demand colliding with supply chain disruptions exacerbated by the invasion of Ukraine, causing prices to explode across industries, especially food, energy, and durable goods.

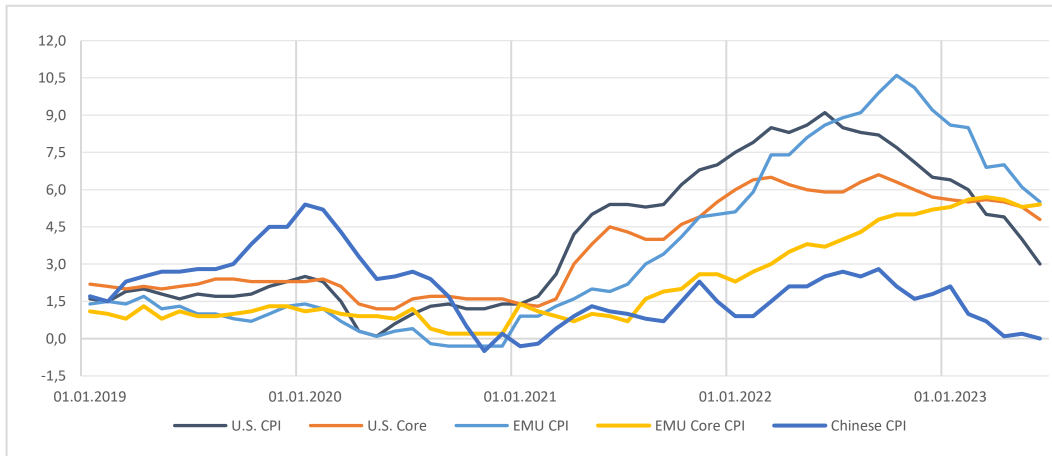
Oil and gas prices have jumped following the Ukraine invasion but the recent plunge in natural gas prices, so critically important for European households, will reduce household utility bills. As a reminder, energy prices accelerated sharply in 2022 (+23.1% on average, after +10.5% in 2021) and food prices (+6.8% on average) increased sharply in 2022.

Supply-chain disruptions abated as demand is cooling off in response to the swift central banks' rate hikes have contributed to ease inflation pressures. In that context, core CPI inflation receded from a peak of 7% to 4.6% in May while headline inflation was only up 3.8%.

Housing market inflation has peaked as the jump in mortgage rates has driven housing affordability to its worst level since 2007. The expected home prices decline of 2.5% in 2023 will bring the CPI shelter component to a normal level.

The persistence of core inflation has emerged as a key risk as it could restrain purchasing power of households and lead to more monetary tightening. However, the stability of energy prices has reduced headline inflation, with positive effects on demand and financial markets.

Exhibit 1: Consumer price index (%)

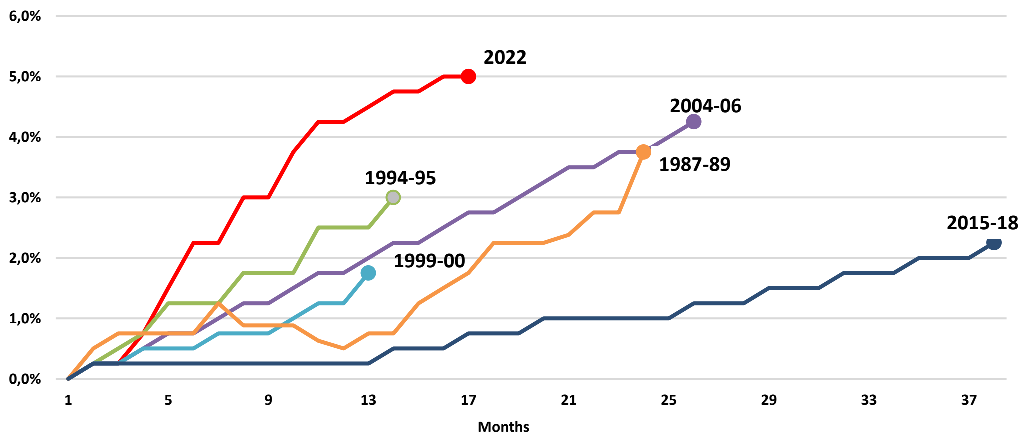


Source: Bloomberg

Monetary Policy

Fifteen months into one of the most aggressive tightening (500 bps since March 2022), the Fed has decided to pause, a "hawkish hold", on rate hikes in June.

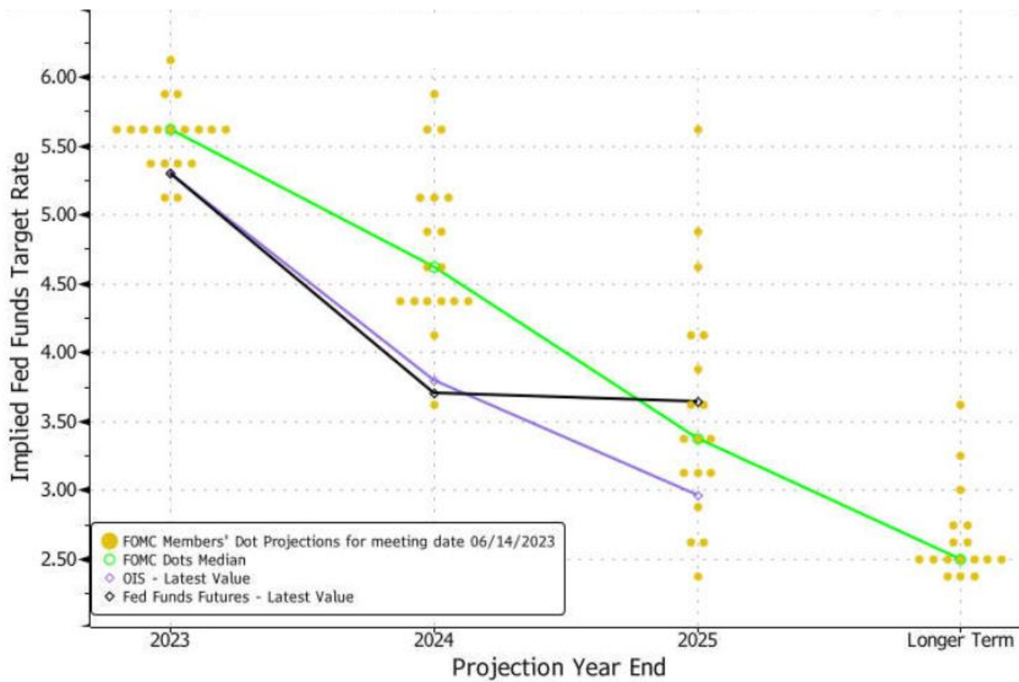
Exhibit 2: Fed funds rate since hiking began (%)



Source: Bloomberg

At the same time, the Fed has signalled that we have not reached the terminal rate yet. Two days after the June Federal Open Market Committee (FOMC), the Fed chairman Jerome Powell announced that the target range. for the federal funds rate would be kept at 5.00 to 5.25% for the time being. According to the "dot plot" (Exhibit 3), the committee members are expecting fed funds target rate range to climb to 5.50 – 5.75% by the end of 2023, implying two more rate hikes.

Exhibit 3: Implied Fed Funds Target Rate



Source: Bloomberg

Bank of America expects two more 25bps hikes from the Federal Reserve this year, while JP Morgan sees only one more hike in July. The former terminal rate forecast stand at 5.5%-5.75% while the later see the rate peaking at 5.25%-5.50%. These new terminal rates coupled with the anticipated path of inflation, indicate that monetary policy will become even more restrictive through 2024 on an inflation-adjusted basis.

In Europe, the progressive firming of core inflation has forced EU monetary authorities on the path of more forceful monetary tightening. In May, the ECB lifted policy rates by 25 basis points.

In the UK, persistent high core inflation, 7.1% year-over-year (YoY) in May, up from 6.8% in April (highest level since March 1992) prompted the Bank of England to raise rates by 50 basis points, its 13th consecutive increase. Most recent data showed annual UK consumer price inflation was 8.7% in May, unchanged from the previous month.

Although the market had partially priced in the largest increase, the UK is certainly the worst among major western economies as rising energy and food prices, have been magnified by structural labour shortages.

As an outlier, the Bank of Japan remained dovish and will continue to support the fragile economic recovery despite stronger-than-expected inflation, exceeding its target for over a year. In fact, inflation has exceeded the BoJ target of 2% for 13 straight months. The BOJ's decision contrasts with that of the ECB, which raised borrowing costs to a 22-year high in June.

A more aggressive global tightening or higher-for-longer conditions, which gradually become more consensual, continue to raise worries about the likelihood about a policy mistake, particularly with the signals sent by the yield curve inversion and money supply growth.

The global supply-chain pressure index plummeted

The latest Global Supply Chain Pressure index released by Federal Reserve Bank of New York fell to its lowest level on record in May, indicating the bottlenecks that largely fuelled inflation lately are largely resolved.

Exhibit 4: Global Supply Chain Pressure Index (Standard deviations from average value)

Source: Bloomberg

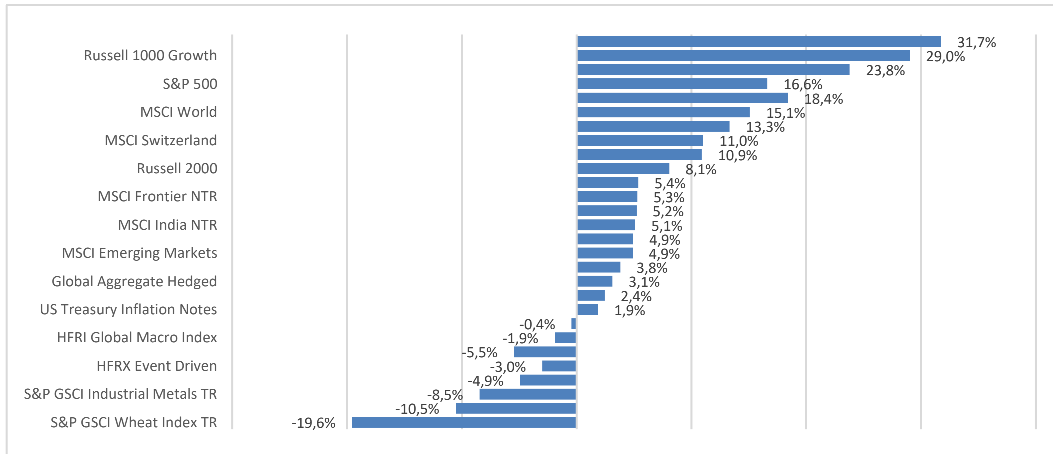
The drop in the index, which comprises of 27 components, suggest the pressures on supply chains that began with COVID-19 have now abated, which is excellent news for inflation.

Summary

Over the last 18 month, the most striking features of the economic and market environment has been the resilience of the global economy to aggressive rate hiking cycles and shocks among others the invasion of Ukraine or the dislocation in the banking sector. As far as global growth is concerned, the consensus expectations has been revised higher. This resilience is highlighted by the fact that Composite PMIs remained at a healthy level in June 2023 – up from December lows. Unfortunately, we sense that this improved situation will likely be followed by weakness as tighter monetary policy is having an impact.

First half 2023: Financial Markets

Exhibit 5: Index Returns in US Dollar (%)



Source: Bloomberg

2022 was not great for many investors and for stocks and bonds as both fell in tandem due to rising and persistent inflation that led to a global and rapid increase in central bank interest rates. Ordinarily, both asset classes falling simultaneously is uncommon (only the third time in 100 years using US equities and bonds). The fall of both put into question the traditional 60/40 (equities/bonds) portfolio. Fortunately, we had an allocation in alternatives strategies that mitigated our risk and protected our portfolios against such market falls. Investors had a more pleasant start to 2023 than they had in 2022. Markets were in celebration mood in 1H, an outcome better than what was expected as investors ignored uncertainties as shown by the CBOE Volatility Index, a gauge of investors' fear, which dropped to 14.6, its lowest level since February 19, 2020.

Fixed Income

All fixed income segments delivered positive returns with T-bills posted gains of +2.5%, its best start since 2000, while longer maturities government and corporate investment grade (IG) posted gains of 3.0% with a negative second quarter especially in May as long-dated interest rates spikes causing some heavy losses on long treasury bonds. On the side of real yields – yields adjusted for inflation expectations, have reached their highest level in year.

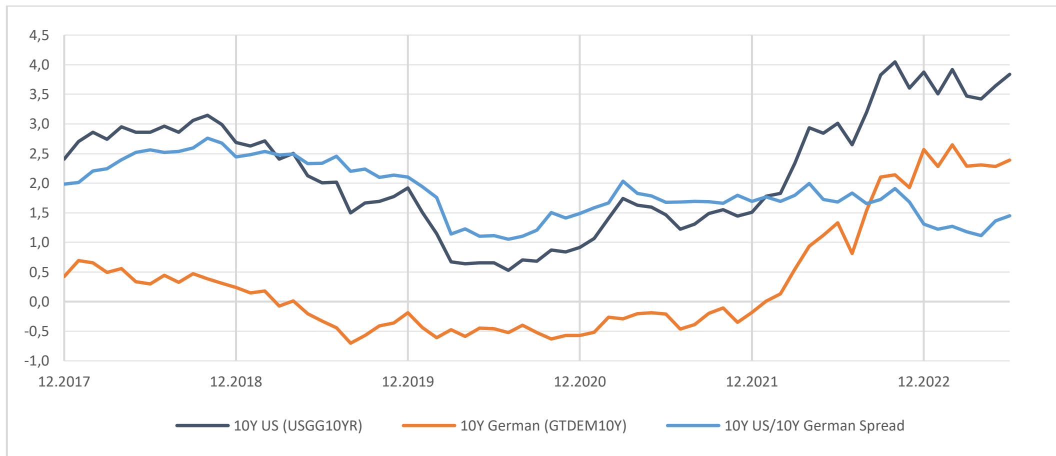
Table 1: Performance Dashboard(1H23)

	Total Return in U.S. Dollar (%)
Global Aggregate Hedged	2.96%
Global Aggregate Unhedged	1.43%
US Treasury	1.59%
US Treasury Inflation Notes	1.87%
US Corporate (IG)	3.21%
US Corporate (HY)	5.38%
Pan-European (HY)	4.79%
EM Sovereign	3.88%
EM Local Currency	1.69%
EM High Yield	3.71%

Source: Bloomberg

Under the influence of the Fed tightening policy, the front-end of the US Treasury curve shifted upward with two years treasury yield at 4.9% at the end of June while the ten years barely moved since December at 3.8%. In Europe, the German 10-year rates were lower than in December at 2.4% versus 2.6% while the 2-year German yield have surged to 3.19%, above their December print of 2.7%

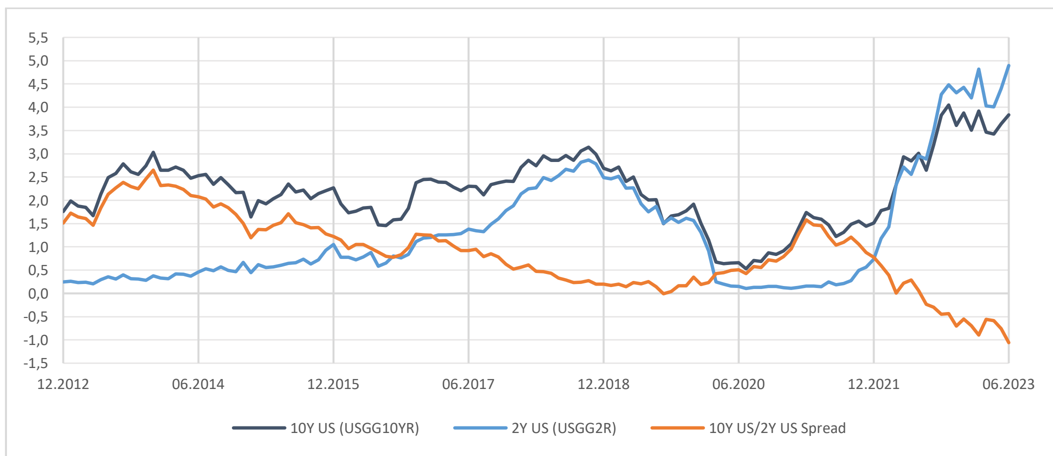
Exhibit 6: 10-Year Government Bond Yield (%)



Source: Bloomberg

The US yield curve remained inverted, with spread between 2-year and 10-year Treasury yields widening to its deepest level in decades.

Exhibit 7: 2-Year/10-Year Government Bond Yield



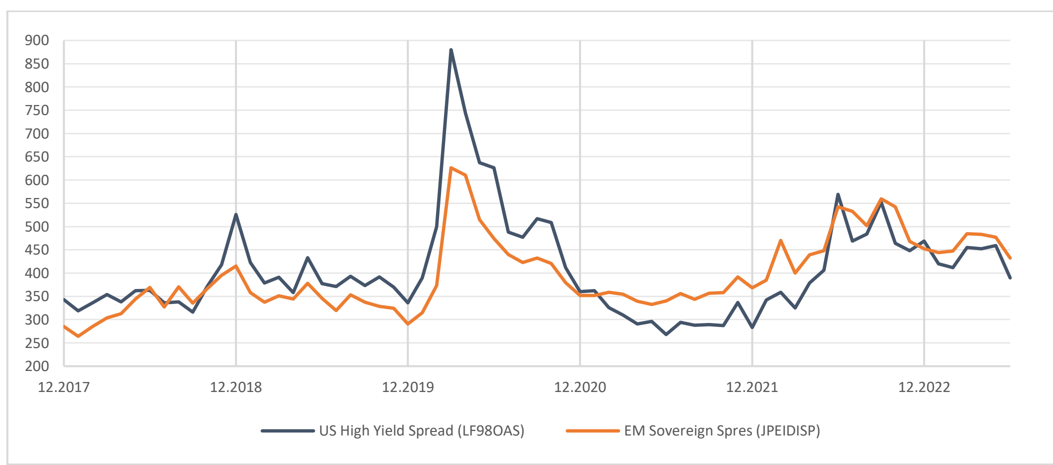
Source: Bloomberg

Global Investment Grade (IG) corporate bonds underperformed high-yield corporate bonds by 200bps with 3.1% and 5.4% respectively. Bond spreads peaked in March and then returned to where they were at the start of the year.

Emerging Market Debt (EMD)

EMD index returns were positive across the board in 1H. The Hard Currency aggregate index gained 3.6% with spread tightening by 21bps at 432bps while Local Currency sovereign delivered only 1.7%.
EMD benefited from tighter spreads, in synch with other spread exposure as the soft-landing scenario was gradually priced in. However, this positive contribution was partially offset by the negative impact from higher US treasury yields (EMD Hard Currency). The high yield segment has been the best performer with 3.7% in 1H thanks to tighter spreads while headwinds from interest rates kept IG return more contained.

Exhibit 8: Emerging Market Debt and U.S. High Yield spreads



Source: Bloomberg

Equities

It became evident in June that financial markets have been pricing in the return of the Goldilocks, where developed economies avoid a severe downturn with fading prices, allowing central banks to shift their focus toward supporting growth rather than fighting inflation.US large cap equities are up nearly 17%, fourth-best first half in the last 25 years, while the US equal weighted index is only up 7%. The European large cap index is up 13% in Euro, but the traditional defensive markets such as Switzerland and the UK delivered relatively poor returns. The latter even delivered a negative return in local currency over the quarter, bringing the year-to-date underperformance to more than 10%. Emerging market equites delivered positive absolute returns but have struggled versus developed markets so far year-to-date due to China. The year started positively around China's reopening but rapidly showered by economic data fall short of expectations. In the US, the second quarter returns of growth, quality and technology indices delivered comparable returns to those registered in the first quarter with + 7.1%, 11.2% and 12.4% respectively bringing the first half return to 13.6%, 23.1% and 31.7%. This technology led surge contrasted with poor returns encountered across the commodity complex such as energy and industrial metals as well as in the largest emerging market namely China where the All-share index is down almost 10% during second quarter.

Exhibit 9: Global Equity Index - Local Currency (rebase 31.12.2016=100)

Source: Bloomberg

Only a handful of tech shares have been responsible for most of this year's gains despite higher rates. The seven-largest companies in the S&P 500, all tech companies, are up 86% on average year to date!! Meanwhile, the other 493 companies in the S&P 500, in aggregate, have barely moved this year.

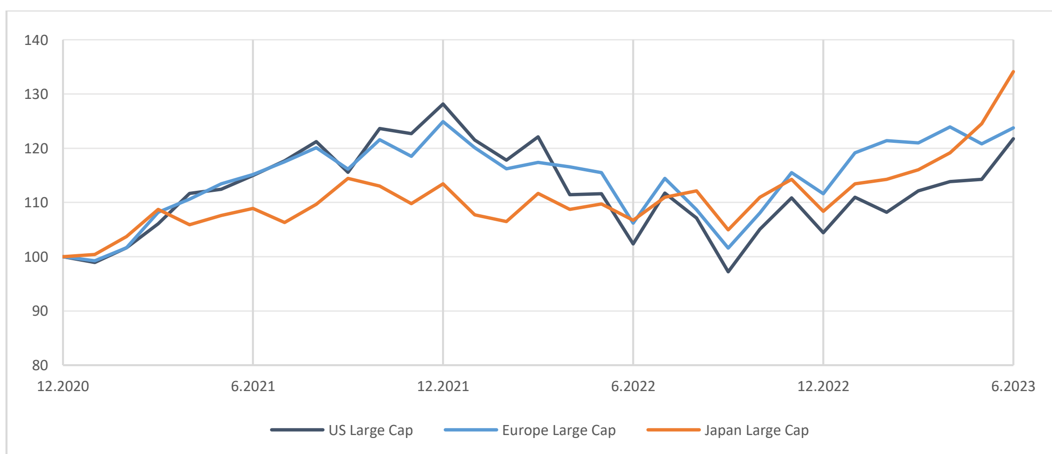
The idea that Artificial Intelligence will generate additional growth and productivity gains benefits of Artificial Intelligence algorithms overtook concerns about the negative effects of higher interest rates that have an adverse impact on long-duration assets such as companies with the bulk of their profits far out into the future.

As an illustration, shares of chipmaker NVIDIA soared, Apple's market value breached the $3 trillion mark for the first time, Meta and Tesla saw their share price more than double.

This parabolic price action on lofty valuation stocks can certainly last, but valuation is back to pre-pandemic levels making the market vulnerable to any investor loss of confidence or earnings disappointments. This cocktail of price acceleration and narrow market advance have some similarities with the dotcom era that finally burst in March 2000!

This year has showed a wide dispersion of returns among standard index providers. While growth stocks outperformed value stocks this year, index construction rules and composition can lead to different outcomes. As an example, Microsoft was the second-largest weight in the S&P 500 Growth Index and the top position in the S&P 500 Value Index! The leading e-commerce company Amazon.com was the six-largest holding in the S&P 500 Growth and the third holding in the S&P 500 Value Index.

Exhibit 10: US, European and Japanese equity indices (rebase 31.12.2020=100)

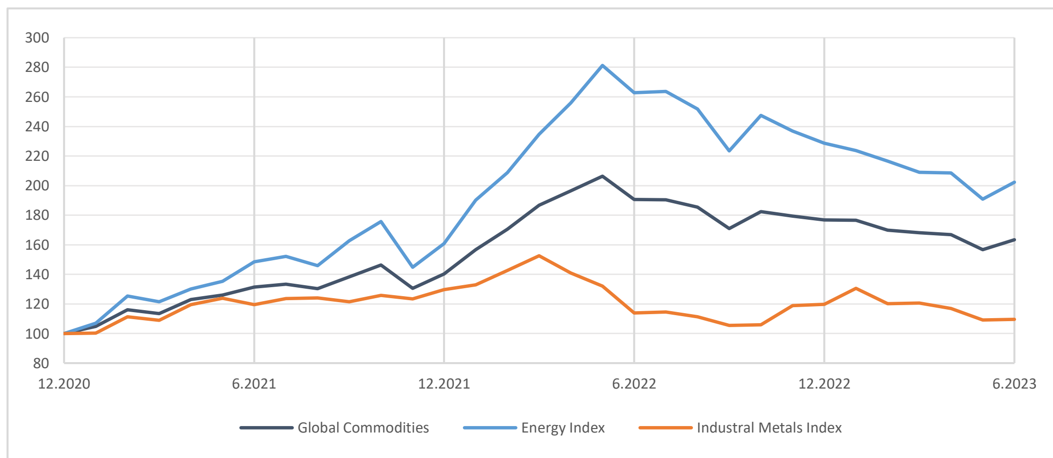


Source: Bloomberg

Commodities – Oil and Industrial Metals

The Bloomberg Commodity index declined for the fourth time in the last five quarters.
Broad commodities continued their weakness in part due to economic weakness in emerging markets, particularly in China and Europe, and to stronger U.S. dollar.

Exhibit 11: Commodity Indices (rebase 31.12.2020=100)

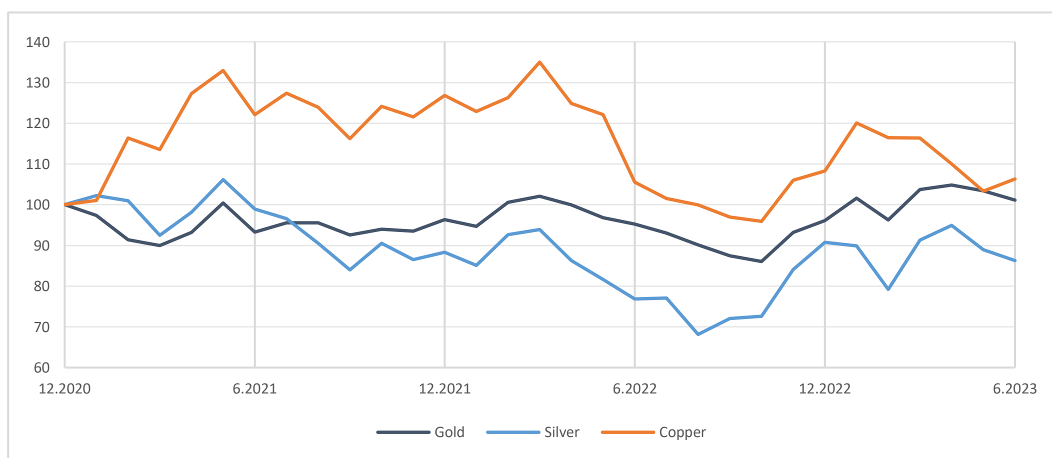


Source: Bloomberg

Commodities – Gold

In precious metals, gold delivered strong return in 1Q (+8.0%) but gave up some of these gains in 2Q ending 1H up 5.2% in USD (US$1,912.25/oz) while Silver ended the period down 4.9%.

Exhibit 12: Gold, Silver, and Copper (rebase 31.12.2020=100)

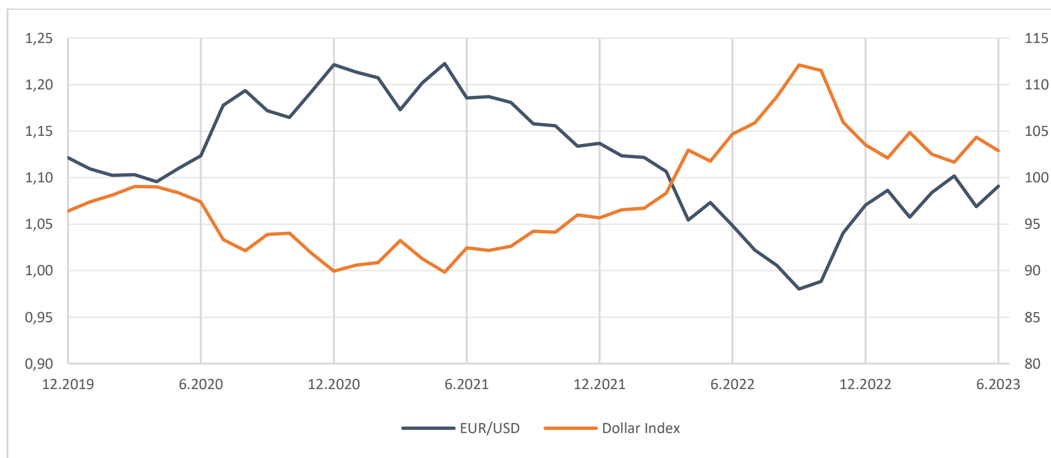


Source: Bloomberg

Currencies

After reaching parity with the Euro in 2022, the U.S. dollar weakened in fourth quarter 2022 and in the early months of 2023 as more attractive real yields (government bond yields less the rate of local inflation) and recession risks in Europe appeared more pronounced compared to the US.

Exhibit 13: Currency Performance against U.S. Dollar (%)



Source: Bloomberg

Table 2: Currency Performance Dashboard (%)

	1Q23	2Q23	1H23
Dollar Index	(0.91)	0.44	(0.59)
Emerging Markets Currency Index	*1.93*	*(0.91)*	*0.95*
EUR/USD	*1.32*	*0.72*	*1.91*
CHF/USD	*1.09*	*2.22*	*3.22*
GBP/USD	*2.16*	*2.97*	*5.13*
EUR/CHF	*0.27*	*(1.53)*	*(1.27)*
JPY/USD	*(1.18)*	*(8.15)*	*(9.14)*
CNY/USD	*0.40*	*(5.32)*	*(4.91)*

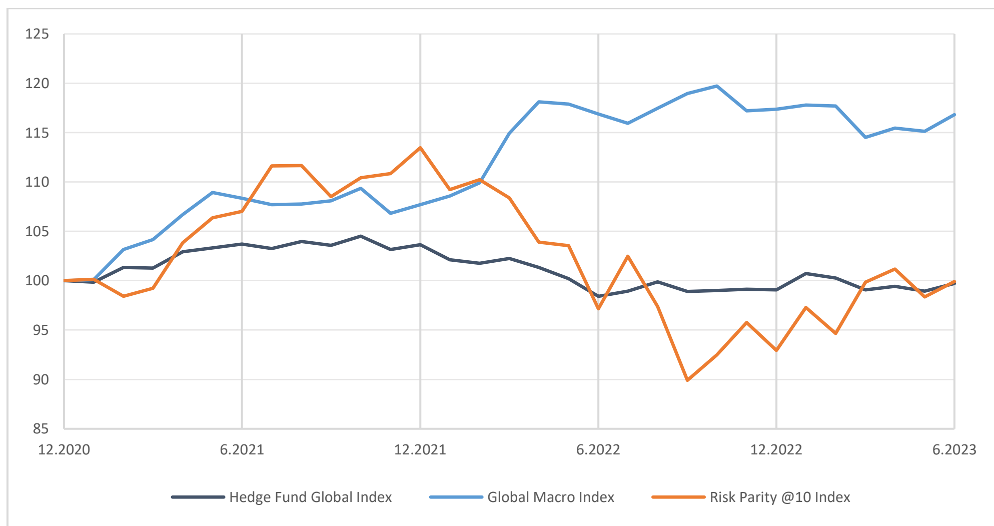
Source: Bloomberg

The Swiss franc has done well this year, helped by the interest hikes orchestrated by the Swiss National Bank (SNB), trading near its highest level since May 2021 against the U.S. Dollar. Since the end of February, the franc has strengthened by 5%, among best-performing currency in the G-10 in that period.

Hedge funds

Uncorrelated Macro strategies, which include trend-following CTAs posted modest gains in 2023. The HFRX Macro/CTA index delivered a negative return in the first quarter (-2.3%) recouped in the second quarter (+2.8%) bringing the index barely in positive territory for the year (+0.25%).

Exhibit 14: Global Hedge Fund Return (rebase 31.12.2020=100)



Source: Bloomberg

Table 3: Hedge Fund Performance Dashboard (%) in USD

	1Q23	2Q23	1H23
Global Hedge Fund	*0.02*	*0.64*	*0.63*
Equity Hedge	*0.81*	*2.13*	*2.96*
Equity Hedge – Equity Market Neutral	*-0.29*	*1.19*	*0.89*
Event Driven	*-0.20*	*-2.75*	*-2.99*
Global Macro	*-2.43*	*2.01*	*-0.47*
Global Macro – Systematic Diversified CTA	*-5.75*	*6.78*	*0.70*
Relative Value – Multi-Strategy	*0.99*	*0.90*	*1.88*
Relative Value Fixed Income Convertible Arbitrage	*3.10*	*2.24*	*5.38*
Risk Parity @ 10	7.46	0.12	7.49

Source: Bloomberg

Second-half 2023: Economic outlook

Global economic activity improves

The global economy is showing signs of improvement. The reopening of China has provided some, but limited pick-up in activity while lower energy prices eased pressures on households. However, restrictive monetary policy will constrain further aggregate demand. Global real GDP is projected to moderate from 3.3% in 2022 to 2.7% in 2023, the lowest annual rate since the global financial crisis, and then edging up to a subdued 2.9% in 2024.

The improvement in 1H is driven by the decline in energy prices, particularly in the price of natural gas, and better prospects for China.
Although growth will gradually pick up through 2024, the downside risks have increased as inflation remains stubbornly high threatening a fragile growth improvement, forcing central banks to tighten monetary policy more aggressively.

Table 4: Real GDP growth projections (%, year-on-year)

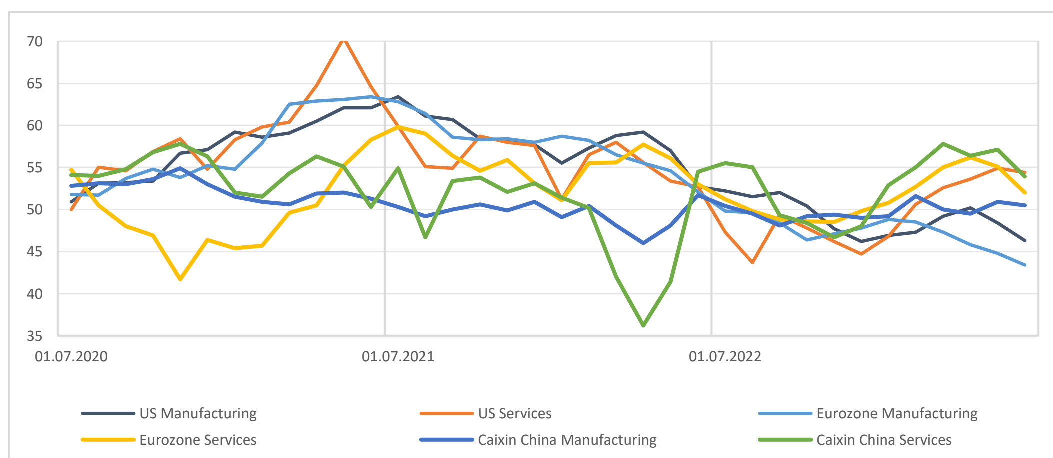
	2023E	2024E
World	2.7	2.9
United States	1.6	1.0
Euro Area	0.9	1.5
UK	0.3	1.0
Japan	1.3	1.1
China	5.4	5.1
India	6.0	7.0

Source: OECD Economic Outlook, June 2023

Recent activity indicators mixed

The activity indicators have been mixed. The manufacturing sector has been weak, so most of the improvement in early 2023 has been more apparent in services sectors, helped by a rebound in consumer demand in China and solid growth in the United States. Tighter monetary conditions are becoming visible in real estate markets. House prices have started to adjust to more restrictive conditions.

Exhibit 15: Purchasing Manager Indexes (PMIs)

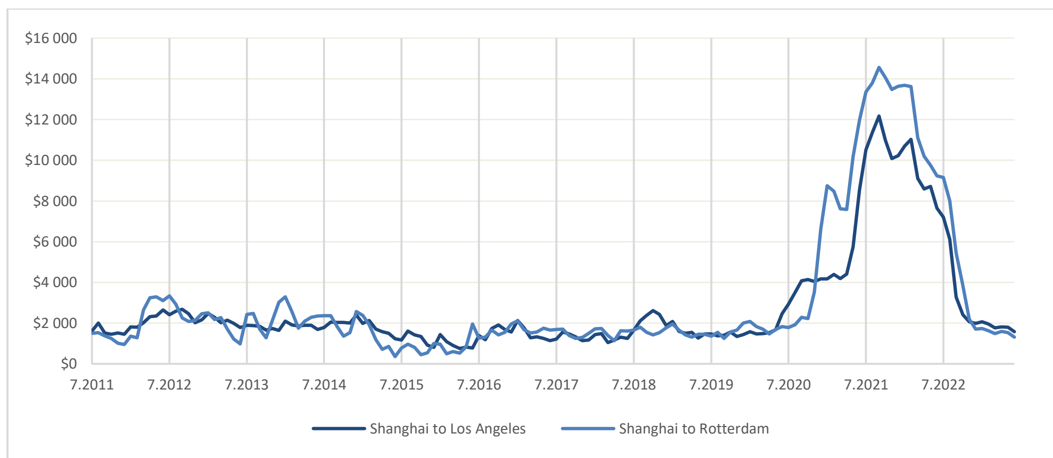


Source: Bloomberg

Global trade recovered partially

Global trade volumes recovered in the first quarter 2023, but global goods trade remained very weak. Transportation prices and shipping volumes remain weak and survey measures of new manufacturing export order stay at low level, even if services export orders improve.

Exhibit 16: Shipping Cost (US$/40t Container)



Source: Bloomberg

As global supply bottlenecks have been mostly resolved, and China's economy now fully reopened, subdued demand for goods and commodities will weigh on global trade growth.

Despite concerns about potential risk to supply of key agricultural products from Ukraine, global food exports have held up relatively well.

Financial conditions tight and volatile

The failure of some regional banks and forced takeover of Credit Suisse generated significant tensions in the global banking system as illustrated by the spike in banks' credit default swap (CDS) but timely policy measures helped to stabilize financial conditions. The rising cost of funding for banks and additional capital liquidity requirement are likely to result in more restrictive credit conditions.

Inflation trends down but tight labour drives up services inflation

Inflation in the largest economies continues to moderate as slower economic activity has weakened overall demand. Inflation expectations in emerging economies are gradually revised downwards as bottlenecks in supply chains are improving and due to lower commodity prices.
Food prices showed moderate growth in the first half of the year, but rising prices of services and the high core inflation remain a concern as tight labour markets fuel wage growth. Hence, the general conditions of the labour market, and therefore sustainable wage growth will contribute to the inflationary pressure in 2023 and 2024.

US inflation is forecasted to reach 4.2% in 2023 and ease to 2.5% in 2024. Lower energy prices and restrictive monetary policy are both contributing to slowdown price increases. Lower energy prices have largely eased somewhat the inflation risks in the Eurozone. German and French inflation forecasts are 6.4% and 5.2%, respectively.
Inflation in Brazil and India are forecasted at around 5.1% in 2023 and to moderate to 4.6% in 2024 for both countries. In China, price pressures have remained weak on the back of a slower recovery in consumer demand. So contrary to developed economies, China inflation is set to rise in the second half of 2023, as domestic demand picks up.

Conclusions

We expect that higher interest rates will have an increasingly adverse impact on the economy. First, central banks want to prevent permanent high inflation caused by extra-loose monetary policy. Contrary to their historical behaviour, central banks will wait longer to assess the state of the economy before cutting interest rates.

Real (US) interest rates have turned from negative to positive. Higher real interest rates are far more important than nominal interest rates for the economy. Hence, higher real interest rates increase the risk of a more severe economic slowdown. Even in absence of rate hikes, real interest rates will rise in line with the decrease of inflation.

Second-half 2023 : Asset Class Views - June 2023

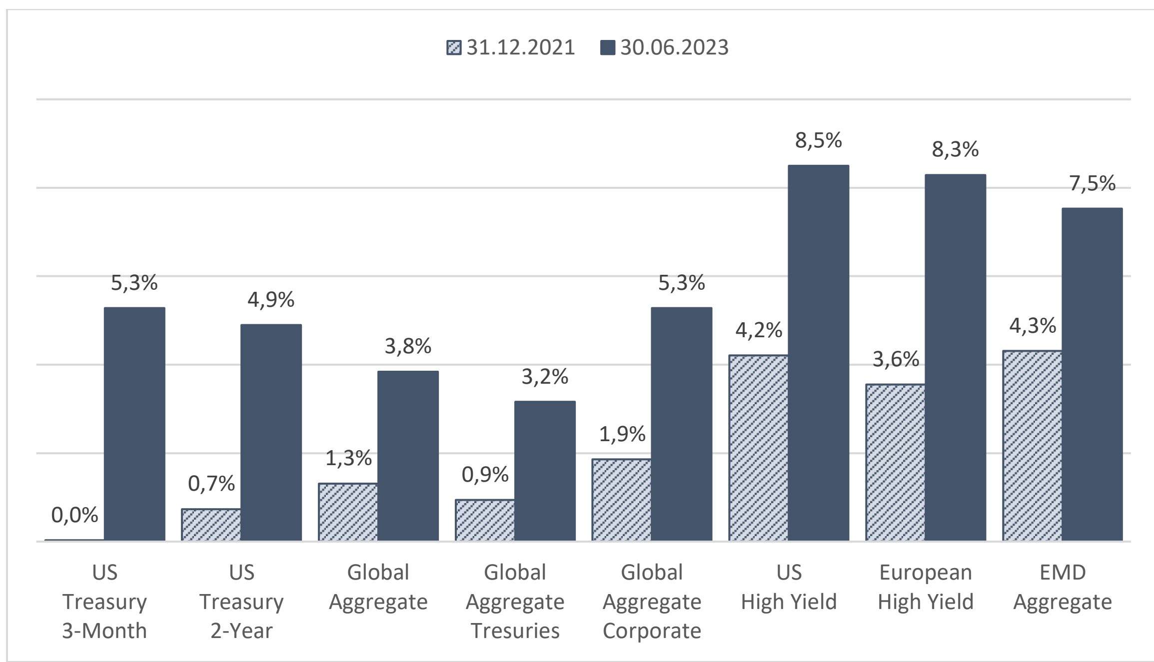
Main Asset Classes

A transformed landscape for most asset classes

2022 was one of the worst years ever for bond markets, largely due to the breath-taking pace of monetary tightening. However, this means that market conditions have improved significantly for fixed income investors as higher risk-free yields and average credit spreads constitute a much stronger starting point. It is also possible that peak long-term yields might have already been reached, so duration risks are much lower than a year ago. All this contributes to the better risk/return profile of the asset class.

Fixed Income

Exhibit 17: Bond Yield (%)



Source: Bloomberg

DM Government Bonds

The higher-for-longer policy rates have improved the prospect for short-dated government bond. In that context, we prefer short-term government bonds for their attractive income as short-term interest rates price the higher for longer theme.

We remain underweight in U.S. treasuries as we still expect higher long-term yields. In the EU including the UK, we remain underweight but would opportunistically increase positions when markets are better reflecting higher for longer policy.

Credit Investment Grade (IG) and High Yield (HY)

High quality corporates (IG) generally offer defensive features in tough times and offer attractive yield (5.3%) at this juncture. However, current spreads are tight and are not reflecting the risk of the upcoming economic slowdown, so some cautiousness is warranted despite strong corporate fundamentals thanks to high liquidity accumulated and low refinancing needs. The higher borrowing costs will be more painful for lower quality corporates (HY), which have less cash flow and higher short-term financing needs even if HY issuers have improved their balance sheets. Even if yield is back closer to long-term average at 8.5%, current spread of 390 bps for US high yield corporate and respectively 456 bps for their Pan-European high yield corporates do not compensate investors for these risks.

Emerging Market Debt (EMD)

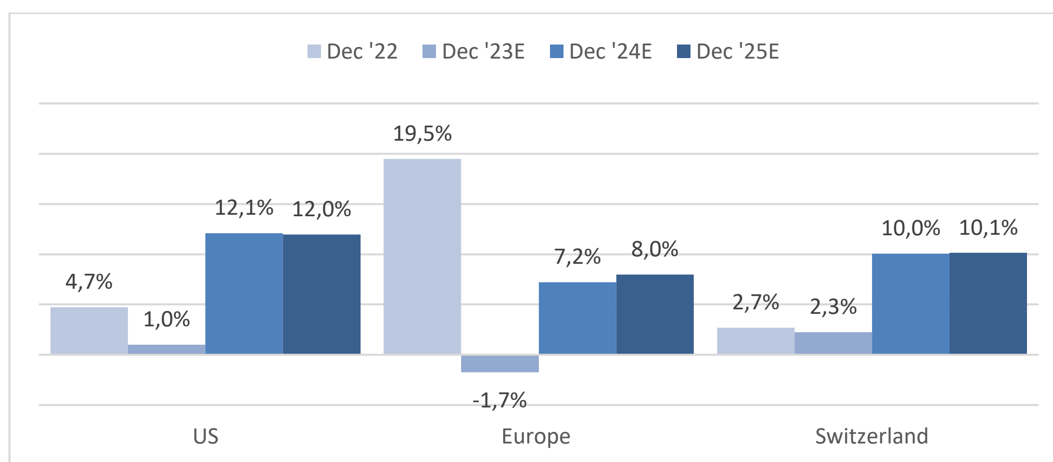
Our view is that the US economy will continue to slow, eventually enter a recession towards end of 2023 while EM GDP growth will be around 4% for the year, opening a period of higher EM growth relative to DM growth. Although some uncertainties remain on the Fed Reserve terminal rate, we are certainly getting closer to the end of the tightening cycle, which should push down interest rate volatility. This repricing of interest rate risk has already started when we look at volatility indices. In most emerging countries inflation and raising rates are behind. Unlike in the US, core inflation has cooled down fast and is expected at 5%. Many emerging market central banks have already reached the peak of their interest rate hiking cycle and will eventually begin to cut them from current extraordinary high level. The EMD’s yield is high relative to its long-term history caused by the elevated spread on the HY sovereign that has exhibited sings of stress. These distressed countries bonds are trading at large price discount and have pushed up the average spreads on the index. The BB+ segment is trading at around 450bps while single B rated bond spread have jumped above 650bps.

Equities

Earnings Outlook

In the US, the S&P 500 is expected to report a year-over-year decline of 7.1% for 2Q2023, which would be the largest decline since 2Q 2020 and the third straight quarter of decline. Looking ahead, analysts still expect some earnings growth for 2H2023. For 3Q23 and 4Q2023, analysts are forecasting an earnings growth 0.1% and 7.6%, respectively. For 2023, analysts predict earnings growth of around 1%.

Exhibit 18: Earnings growth (%)



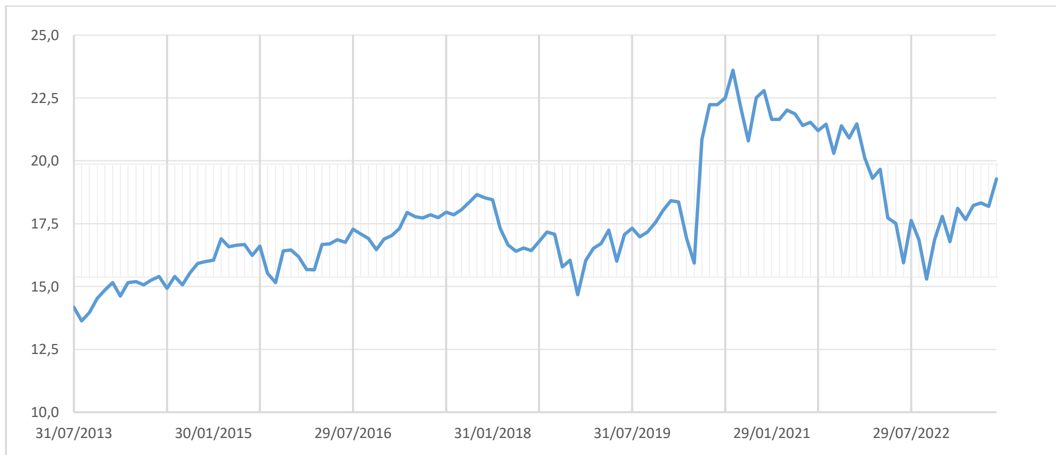
Source: Factset

In Europe, the Refinitiv I/B/E/S estimated earnings growth for the 2Q23 through 2Q24 are -8.3%, -8.7%, -3.2%, -9.1% and 9.0%, respectively.

Valuation

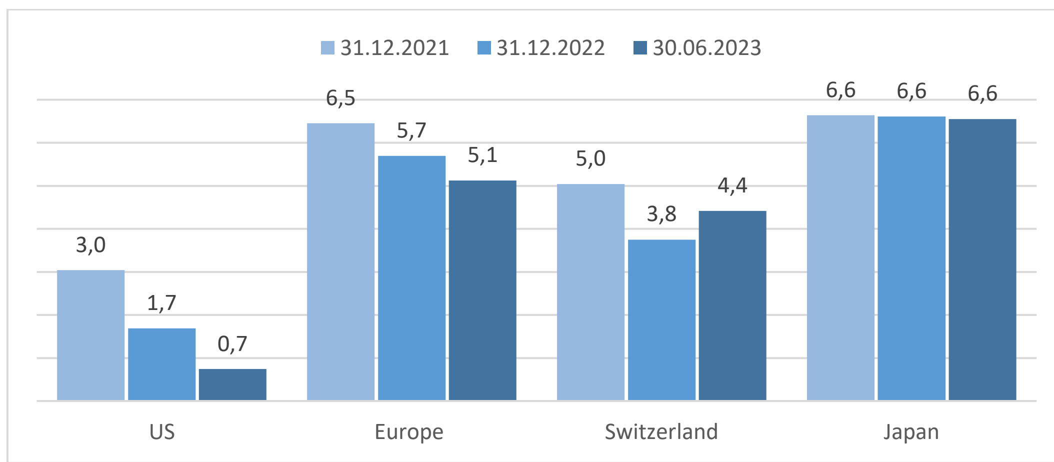
The US equity market is trading above multi-year averages across various metrics e.g., 12-month forward price-earnings, Shiller real P/E ratio, price-book (P/B) ratio.

Exhibit 19: US Equity Valuation (Forward 12-Month P/E Ratios)



Source: Bloomberg

Exhibit 20: Equity Risk Premium [1] (%)



Source: Bloomberg

[1] Earning Yield – 5-Year Bond Yield

Developed Market (DM) Equities

Stocks certainly surprised investors in the first half of 2023, with indices notching double-digit returns in the US, Europe, and Japan even with the headwinds caused by the fastest rate-hiking cycle since the 1980s.

US Equities – Historically, market performance between Fed's last rate hike and first cut has been driven by economic conditions. Equities were up in 1984, 1995, and 2018 when the economy avoided recession. Sharp drop in inflation from high levels has had positive impact on equities like in 1953, 1974 and 1980. As we expect a "higher-for-longer" background, we do not expect neither inflation nor interest rates to go down before next year.
The still-inverted yield curve remains an issue as it has historically been associated with recession. Since 1978, we have experienced 12 yield curve inversions that last around 18 months before recession hit. So far, we have had an inverted yield (2Y/10Y) for 11 months.

European Equities – Since 2007, European equities have underperformed their US counterparts in local currency terms (Exhibit 19). The principal driver of this poor relative performance is explained by the earnings growth differential between these markets.

Exhibit 21: Relative performance of European versus US equities (total return in local currency)

Source: Bloomberg

Japanese Equities – The BoJ's loose monetary policy, strong balance sheet and attractive valuation have supported the market. The main risk for the Japanese equities would be a massive reversal of yen-funded carry trades in a risk-off phase, causing the yen to rise sharply.

Emerging Market Equities

Emerging markets posted positive return in first half 2023, however they lagged developed markets by more than 10% despite the weaker U.S. dollar. However, we see several reasons to remain optimistic about the ability of emerging markets to do well in the second half:

Divergent GDP growth: Developed economies (US and Europe) GDP growth are slowing as emerging market ones are healing. Emerging market central bankers are at a different point in their monetary tightening cycle whereas central bankers across developed economies are taking interest rates close to peak levels to cool down inflation. As detailed above, emerging market GDP growth is expected to surpass the growth of developed economies. The magnitude to that gap has generally been associated with an outperformance of emerging market (EM) equities versus developed market equities.

Earnings Growth: Over the last decade, EM stocks posted mediocre earning per share growth but are now poised to show strong growth outpacing earnings growth expectations of major developed markets like the US or Europe.

Emerging Asia leads the way with China and India forecasted to growth by more than 5%. China's economy is facing headwinds but the potential to outstrip developed economies' sluggish growth remains.

Attractive Valuation: Finally, emerging market equities are trading at attractive relative valuations to developed markets. On a Shiller PE basis, the current discount is about 50 percent.

Commodities - Gold

Gold has served as a reliable "safe heaven" asset and inflationary hedge during time of severe economic and market stress. It has not departed from that rule in 2023, especially in the first quarter, with mounting uncertainties about the inflation, US debt ceiling and terminal rates.

A mild US contraction and cooling inflation would likely give way to a more neutral second half for gold as investors would favour risk-on assets. Conversely, a more pronounced economic downturn would be a more positive environment for gold, thanks to an increase in volatility and risk-off appetite.

Hedge funds

Prevailing market conditions are supportive for hedge fund strategies as they provide alpha sources from markets and an effective portfolio diversifier in periods of drawdowns.

Global Macro – We expect Global Macro strategies to perform well as uncertainties persist and inflation outcome is skewed to either matching or exceeding inflation expectations currently priced in. The end of the quantitative easing era, a time where the quest for yield higher up the risk curve and beta-driven strategies were more attractive than multiple alpha sources, should lead to higher dispersion where macro managers can seize diversified alpha opportunities.

The trend towards deglobalization implies economies to be less connected, and monetary and fiscal policies will diverge leading to high volatility in rates and currencies and dispersion among and across asset classes and regions, an ideal backdrop for skilled macro managers.

Risk Parity – Systematic risk parity strategies are ready for a comeback as bonds re-establish their traditional role as portfolio diversifier. As recession risk is mounting, it might lead to tougher times for equity strategies while beneficial for long-dates bonds. Since risk parity strategies are overweight fixed income, that creates a favourable backdrop.

Long/Short – Uncertainties increase dispersion of outcomes as analysts express more divergent views, a situation that is generally associated with greater alpha opportunities favourable for skilful Long/short (L/S) managers. As we expect limited upside for equities and tighter spreads from current levels, we value the benefits of a reduced directionality of L/S strategies and the idiosyncratic nature of the return stream.

Currencies

In this period of global interest rate normalization, we have witnessed the re-emergence of Momentum and Carry as drivers of currency returns.

U.S. Dollar (USD): remains under pressure

The difference between the Fed and ECB monetary tightening cycle in the next few quarters will be a key driver of EUR/USD exchange rate. Market expectations are that the Fed will stop hiking a few months before the ECB. In the short-term, a hawkish ECB caused by high and sticky inflation keeps the Euro supported as prospects of future hikes are kept alive. The major risk of that policy is a deeper recession in the euro area that will ultimately force the ECB to cut rates aggressively to support the economy and, only then, start weakening the Euro.

Japanese Yen (JPY): benefits from narrower rate differential

Apart from being at odds with policy tightening in other developed economies, the BoJ loose monetary policy seems untenable as inflation has normalized, reducing the need for an extra loose monetary policy. The prospect of abandoning the Yield Curve Control regime remains intact. Market expectations for both central banks imply that the interest rate differential should narrow and therefore strengthen the Yen. A stronger Yen would trigger some carry trades to be closed.

Chinese Yuan (CNY): under downward pressure

Disappointing growth and speculation of policy support has weakened the yuan putting some competitive pressure on other emerging market currencies. In addition, expectations of rate cuts by emerging market central banks will reduce the interest rate differential of EM currencies versus developed market currencies. We expect neither opportunities nor risk in emerging market currencies going forward.

CHF: Set to shine in global rate cuts

The SNB has embarked on an extremely hawkish tone in the past few months even as Swiss inflation remains well below other developed economies. The May inflation was released at 2.2% year-on-year, the lowest since the Ukraine invasion. Like gold over the past two decades, the franc performs well when major central banks provide monetary stimulus. Its trade-weighted rate strengthened 10% during the cutting rate cycle of the Fed and ECB in 2001 – 2002. It rose 13% during the early part of 2007-2008 financial crisis. When the Fed cut rates in 2019-2020, the Swiss franc advanced about 7%. The Swiss franc remains a good hedge against late-cycle risks and benefits from a more activist central bank as well as better yields compared to the Japanese Yen.

Second-half 2023: Investment Implications – July Asset Allocation

Global growth is slowing, and a broad-based slowdown constitute the main risk. Forward looking indicators suggest that inflation pressures are abating as supply chain have been restored and commodity prices have come down.
US interest rates are at or close to their peak while in Europe some more hikes are expected. In contrast, China's policy remains accommodative and economic stimulus are expected to support the economy. Bond yields offer a compelling opportunity while credit spreads are close to their long-term averages, supported by credit fundamentals.

We consider current risk/reward as unattractive for equities especially as increasing risk of recession in the US and elsewhere, and the still unclear path of core inflation, even though disinflation may have started, and demanding valuation except in Emerging Markets.

Table 5: Asset Class Views

	Strategic	--	-	0	+	++	Tactical
Cash	-			■			2.0
Fixed Income	40.0	□ →	■				36.0[2]
Equities	50.0		■				48.0[3]
Gold	2.0			■	← □		2.0
Alternatives	8.0					■	12.0[4]

Cash

Our 2% cash allocation is residual more than fundamental.

Contrary to the past few years, cash finally provides some yield.

Fixed Income

Economic growth is slowing, but inflation remains too high for central banks to pivot their policy. Developed central banks incremental hikes are expected but most of the journey is behind us while emerging market central banks are assessing when the easing cycle will begin.

Government bond (Duration) – still underweight but gradually closer to Neutral

We have cautiously increased our core allocation as yields become more attractive but conscious of the potential adverse impact of interest rate volatility on long duration bonds despite the increasingly attractive yields across fixed income sectors.
Indeed, today's yields are at an attractive starting point for bond investors and will constitute a key driver of bond total return especially in the "higher for longer" scenario. Even if we have opportunistically increased our allocation, we remain underweight sovereign bonds with a reduced sensitivity to interest rates (lower duration) but look to increase our exposure (duration) once inflation pressures cool down.

[2] Including 5% in L/S credit
[3] Including 2% in L/S US equity
[4] Adding 7% of Long/Short included in Fixed Income and Equities

Investment Grade (IG) and High Yield (Credit) – Overweight but get ready to take profits

Corporate bonds have benefited from the declining fears of a hard landing and uncertainty about the pace of central bank rate hikes as well as declining supply. IG bond spreads are trading at their 10-year average, but overall yield is higher. We expect marginally tighter spreads in 2H2023. The reduction of the odds of a severe downturn and strong corporate fundamentals although revenue and EBITDA have receded from their recent peaks. Rating downgrades have started to pick up in the U.S. leveraged loan segment while the loan default rate is expected at 4-4.5% by year-end 2023. It is important to mention that the current loan market is of lower quality than in prior cycles – single-B loans being a large portion of the overall market. While yields remain attractive on an absolute basis, credit spreads are trading at a level close to the ten-year average. As our central scenario is still expecting weak growth and sticky core inflation, we expect spreads to widen in the second half of the year.

Emerging Market Debt (EMD) – Considering trimming but remain Overweight

Hard Currency (HC) offers a combination of attractive relative real rates versus developed markets and a compelling carry. As US treasury yields have reached new highs in response to better US economic data and probability of persistent sticky inflation. The real yield pickup of Local Currency (LC) over developed markets has fallen sharply as inflation has increased more than nominal yields but is now falling and could provide some relief. The Corporate (IG and HY) spreads are close to average levels but offer additional yield pickup with lower net leverage than US issuers. Chinese real estate continues to struggle for recovery even if encouraging voices of policy support is yet to be acted upon. Overall, EMD remains attractive as disinflation has started allowing EM central banks to cut rates, which should support the Local Currency sector. As the rally progresses, we would consider trimming our exposure, but we remain overweight for the time being.

Equities – Underweight confirmed

Our rather cautious attitude towards equities has been challenged by the unexpected resilience of the US economy and a rally in US mega-tech stocks.

U.S Equities – Underweight

Based on recent Goldman Sachs' Current Activity Indicator and that real retail sales have declined in eight of the past 12 months suggests that the real economy is indeed struggling. Some other worrying macro-observations: yield curve has inverted further, real money supply remains negative, and banks' lending standards are more restrictive. In term of valuation, the forward P/E on the S&P as of June is 21.8, versus the long-run average of 15. We should highlight a valuation discrepancy between the top 7 MEGA stocks, with an average P/E of 32, and the rest of the market at 16.5, closer to the long-term average. While the market ex-mega looks more attractive from a valuation standpoint, their earnings tend to be more sensitive to the economic activity. So, if downward revisions gain momentum, their valuation may start to exhibit more expensive valuations than they do today. In that context, we reiterate our cautious positioning (underweight and low-beta) as US equities offer an unattractive risk/reward payoff (asymmetric risk to the downside but recognize that the momentum encountered during second quarter 2023 can last.

European Equities – Overweight relative to US Equities

Given the economic backdrop and the lagging effects of the ECB aggressive monetary policy, investors should be prepared for tougher times over the next few quarters. But we see a strong rational that will support European equities relative to other major developed markets. First, European earnings have beaten expectations. So far in 2Q23 and in aggregate, companies are reporting earnings that are 6.0% above estimates. Second, the longstanding valuation remains cheap on both a historical and relative basis to US equities and third, the breadth of Europe's markets compared to the narrow leadership observed in the US market.

Japanese Equities – Overweight

We retain a favourable view on Japanese equities due to the confluence of positive tailwinds such as the country's commitment to improve governance, a weaker Japanese yen and share buyback announcements supporting earnings and attractive valuation. We are cognizant of the recent market upswing with equivalent increase in near-term earnings. We also recognize that near-term economic conditions remain challenging globally with weak recovery in China since re-opening and a softer economic outlook out of the US. In case of a short-term pause or correction, we would seize that opportunity to increase further our overweight position.

Emerging Market Equities – Overweight confirmed on earnings dynamic and valuation

Emerging markets have underperformed this year due to global macroeconomic concerns, geopolitical risks, and the trajectory of the U.S. dollar. After years of reduction of the growth differential (since Global Financial Crisis), emerging markets economies will enjoy again a growing economic growth premium over developed markets. Simultaneously, earnings growth is expected to be higher in EM in 2024 versus DM. Valuation levels have reached some of their most compelling levels ever. Currently, EM is trading just under 12x on a price/earnings basis over the next twelve months, or just above its long-term average of 11.3x.

Commodities – Gold: Cut to Neutral

The purpose of gold is to provide diversification in period of market stress and a hedge against inflation and weaker U.S. Dollar. Our gold exposure held remarkably well through 2022 and 1H2023. However, some headwinds should be expected in the second half of year such as with upward pressure on real interest rates combined with downward pressure on the inflation front. For these reasons, we cut our exposure to Neutral, equivalent to an allocation of 2% for 3%. We would not hesitate to increase our allocation to gold if concerns about a deeper recession emerges, while inflation is not fully under control by that time.

Hedge funds: Retain overweight views

We are at a crossroad; either the US economy will have a soft landing, or more rate hikes are required to tame stronger inflation backdrop. In both cases, the resulting market environment is one of high uncertainty with major price and liquidity dislocations. Events of this nature create short-term opportunities for nimble managers but can also mark the birth of new trends. In both cases, macro and trend-following strategies are well positioned to capture such bouts of volatility and reversal. Overall, our hedge fund exposure is by design a low-beta book except for risk parity strategy that provides an efficient beta exposure across asset classes.

Table 6: Hedge Fund Views

	--	-	0	+	++
Risk Parity					■
Global Macro					■
CTAs					■
L/S Credit				■	
L/S Equity				■	

Currencies

U.S. Dollar (USD)

In Europe, the ECB is likely to continue hiking rates while the Fed paused. Overall, we expected the USD to remain weak as better economic momentum and the two-year yield differential are in favour of the Euro, which is still cheap on a purchasing-power parity basis.

ASSET ALLOCATION GRID – EURO – July 2023

For our balanced accounts, we apply the following grid:

	Neutral in %	July 2023 in %		Boundaries in %
Short-term deposits	**-**	**2.0**	➲	**0 – 20%**
Fixed Income	**40.0**	**31.0**	⓿	**15 – 55%**
Government	10.0	3.0		
Credit – Investment Grade	10.0	6.0		5 – 45%
Credit – High Yield	5.0	6.0		
Emerging Market Debt	5.0	6.0		0 – 20%
Flexible	-	10.0		0 – 15%
Equities	**50.0[2]**	**46.0**	⓿	**20 – 60%**
Developed Markets				15 – 55%
Europe	30.0	29.0		
North America	15.5	10.0	➲	
Asia Pacific incl. Japan	2.0	2.0		
Emerging Markets	2.5	5.0		5 – 30%
Commodities	**2.0**	**2.0**		**0 – 15%**
Gold	2.0	2.0		0 – 5%
Other commodities	-	0.0		0 – 10%
Hedge Funds	**8.0**	**19.0**		**0 – 25%**
Risk Parity	3.0	4.0	⓿	0 – 10%
Global Macro	3.0	4.0	⓿	0 – 10%
Trend Following	2.0	4.0	⓿	0 – 10%
Long/Short (L/S)				0 – 10%
L/S Credit	-	5.0	➲	
L/S Equity	-	2.0	➲	
Others	-	-		0 – 10%
	100.0	**100.0**		

DISCLAIMER

The Forum Finance Group S.A. (FFG) is authorised by FINMA as asset manager and registered with the SEC as investment adviser. Although every care has been taken by The Forum Finance Group S.A. (FFG) to ensure the accuracy of the information published, no warranty can be given in respect of the accuracy, reliability, up-to-datedness or completeness of this information. FFG disclaims, without limitation, all liability for any loss or damage of any kind, including any direct, indirect or consequential damages, which might be incurred through the use of this document. The entire content of this document is subject to copyright with all rights reserved. You may not reproduce (in whole or in part), transmit (by electronic means or otherwise), modify, or use for any public or commercial purpose this document without the prior written permission of FFG. Please go to www.ffgg.com for our full disclaimer.

[2] FFG strategic portfolio and MSCI AWCI breakdown as of June 30, 2023

FFG

FORUM FINANCE

1994

The Forum Finance Group SA

65, rue du Rhône — CH-1204 Geneva — P.O Box — CH-1211 Geneva 3 — T +41 22 552 83 00

FFGG.COM