Overview
Outlook - Winter

1st Quarter 2023

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BANCO
CARREGOSA

Editorial

By the Chief Investment Officer

Cycles are an inherent feature of economic systems. Financial markets tend to anticipate these cycles, albeit in a frenetic manner, which often leads to frequent false alarms. Currently, the economic pendulum seems to be swinging, with several developed economies facing a period of recession or very low growth. The equity market pendulum, which has traditionally been quicker to anticipate a turn in the economic cycle, was the first to signal such a turn and will do so again as activity picks up. However, we believe there are not yet sufficient catalysts to reverse the recent decline into a new phase of sustained recovery, which could happen in the course of this year. After a prolonged period of financial repression, we expect 2023 to see the start or intensification of investments with attractive entry prices.

We are facing one of the least surprising recessions in recent years, given how early it was announced and anticipated. This is not unrelated to the fact that the economic downturn was man-made, particularly in the fight against inflation, and with restrictive monetary policies in virtually all economies. The recession was expected and even desired, which may contribute to a certain degree of general anaesthesia. But the future is fraught with risk. Economic downturns, like wars, may be easy to understand in terms of how they begin, but not in terms of how and when they end.

The economic slowdown we are now experiencing was largely a desired outcome, allowing investors to rejoice at the release of softer economic data. The expectation is that if the cause is human, the movement can be reversed as there is an intention to do so, which may not entirely be true. Hoping that the economy will slow down in a balanced way so that activity slows down enough to stop inflation, but not so much as to bring the economy to a more abrupt halt is virtually utopian. It may be possible, but it is unlikely to happen.

In the coming months, investors will focus on how the economy slows down (soft or hard landing), how inflation evolves (fast reversing or sticky), and how central banks react (do they prefer to fight inflation or to stimulate the economy and employment). Two additional aspects should also be taken into account:: the possible start of negotiations between Russia and Ukraine (talk about talk) and the Chinese economic recovery following the lifting of the zero-Covid policy. For each of these scenarios, the most appropriate range of investments will be different and, in some cases, even diametrically different.

In this environment, the investment strategy should include a degree of diversification, combined with a close reading of developments and the capacity for anticipation or rapid reaction.

The correction in the value of financial assets resulting from the rise in interest rates already makes it possible to find reasonable investment opportunities (TARA: There Are Reasonable Alternatives replaces TINA: There Is No Alternative). On the other hand, fears of missing out on a rapid and sustained equity market recovery (FOMO: Fear of Missing Out) are likely to be tempered by reduced global liquidity, expectations of a deteriorating economy and the reduced relative attractiveness of expected equity market returns.

This means that the remuneration of short-term government bonds is proving to be a less risky alternative. Credit risk seems to be better remunerated than equity risk, although in a period of deflation and economic slowdown we are likely to find even more attractive entry points. With regard to the equity market, current prices reflect an equity risk premium that is below its historical average, as a result of the continued expectation of a recovery in the coming months. Sooner or later, the equity market is going to recover and it is to be expected that a premium will be priced into it. From this perspective, exposure to this market should not be zero, but there should be room (in terms of liquidity and risk appetite) to take advantage of a possible phase of greater distrust in market rebound. Opportunities may then arise to acquire long-term assets at attractive prices.

Mário Carvalho Fernandes

Position

Classes	Subclasses	— —	—	Neutral	+	+ +
Liquidity	Sight deposits, Term deposits					
Bonds	Investment Grade Europe (EUR)					
	Investment Grade USA (EUR Hdg)					
	High Yield Global (EUR Hdg)					
	Global Emerging (EUR Hdg)					
Equity	Europe ex-UK					
	USA (EUR Hdg)					
	United Kingdom (EUR)					
	Emerging (EUR)					
Other	Gold, REITS, Infrastructures, etc.					

Macroeconomic Analysis

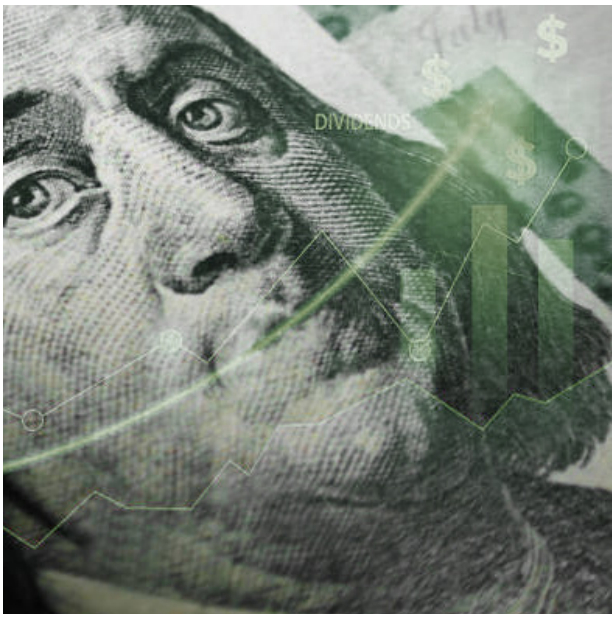
After robust activity growth in 2021, driven by the gradual reopening of the economy, 2022 saw a global economic slowdown as inflation became more persistent and widespread, particularly in advanced economies. After the most severe phase of the pandemic in the spring of 2020 and the discovery of a vaccine later that year, economies gradually reopened in 2021 as vaccination rolled-out worldwide. However, the war in Ukraine in early 2022 compounded and accelerated the rise in the consumer price index in late 2021 due to the difficulties in supply chains and significantly higher energy prices. As a result, the major central banks, in an attempt to curb the highest inflation for decades, adopted a vigorous monetary tightening policy last year, raising their interest rates sharply, further eroding household disposable income already hit by high inflation. As a result, the likely slowdown in demand should have a dampening effect on inflation, but it could also cause a more widespread recession in 2023 than is currently expected. In 2022, the US Federal Reserve (Fed) raised its key interest rate by 425 basis points and the European Central Bank (ECB) increased its key interest rate by 250 basis points. Meanwhile, the Chinese economy has remained on a clear path of zero inflation thanks to its "zero Covid" policy, allowing the People's Bank of China (PBoC) to pursue an expansionary monetary policy. In addition, the reopening of the world's second largest economy at the beginning of the year could boost economic

growth, but also poses a threat to the current fall in inflation, particularly in the advanced economies.

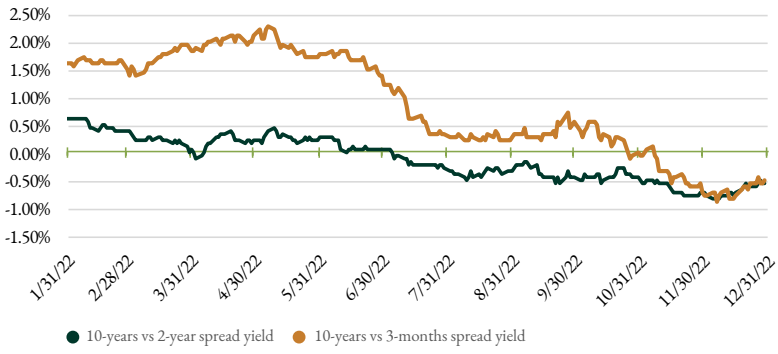
Global economic activity has started to slow down across the board, and more than expected. In December, the Fed revised economic growth down to 0.5% in 2023 from 1.2% in September, and inflation as measured by the core PCE from 3.1% to 3.5%, and also raised the expected unemployment rate for 2023 from 4.4% to 4.6%. The slowdown in wage growth is gradually pushing back a wage-induced inflationary spiral, even though the unemployment rate stood at 3.5% in December, confirming a robust labour market. The US Federal Reserve also expects growth to remain anaemic in 2024 and 2025, at 1.6% and 1.8%, respectively. The cost of living crisis, the tightening of financial conditions in most countries, Russia's invasion of Ukraine and the relative persistence of the Covid.-19 pandemic, particularly in China, weigh heavily on the outlook. The IFM expects the Eurozone to grow by only 0.5%, with Germany and Italy set to contract in 2023 by 0.3% and 0.2%, respectively. The OECD also estimates that growth in the euro area will be only 0.5% in 2023 and 1.4% in 2024, which also confirms the conviction that growth in Europe will be weak in the coming years.

The IMF expects global growth to slow from 6% in 2021 to 3.2% in 2022 and 2.7% in 2023. This is the weakest growth since 2001, excluding the Great Recession of 2008-09 and the most severe phase of the Covid-19 pandemic in the spring of 2020. After a rise in global inflation from 4.7% in 2021 to 8.8% in 2022, the IMF expects a fall in consumer prices to 6.5% in 2023 and to 4.1% in 2024. In its latest Economic Update on 11 October 2022, the IMF said that the monetary policy should remain geared to price stability and that fiscal policy should be able to ease pressures on the cost of living while remaining sufficiently restrictive in line with monetary policy, taking advantage of high inflation rate to reduce the high debt-to-GDP ratio, especially in industrialised countries with weak fiscal positions.

In short, 2023 may well be the year in which the highest inflation for decades recedes, but it also threatens to be the year of recession. The negative slope of the US and European yield curves have been pointing to an economic recession for several months now.



10-year, 2-year and 3-month US Teasury yields



Source: Banco Carregosa

The negative slope in the US yield curve is increasingly visible, with the risk of a recession in the next couple of quarters. The spread between the 10-year and 2-year Treasury yields has been negative for more than half a year, and the spread between the 10-year yield and that of the 3-month Treasury bills, the Fed's preferred measure, turned negative at the beginning of the final quarter of 2022, indicating a recession. Meanwhile, the mismatch between the economy and the yield curve is becoming clearer as the US labour market remains robust, demonstrating the resilience of the US economy. However, the economy has been underpinned by a significant easing of difficulties in supply chains, and an improvement in the supply side is also a factor behind the slowdown in inflation. However, as the rise in interest rates starts to show its negative effects in the first half of the year, the economy could slow down.

Bond Market

2022 will be remembered by investors as one of the most complex years on record, with the most conservative portfolios suffering relatively greater losses than the riskiest portfolios. The spike in inflation from transitory to persistent, combined with the war in Ukraine led to a sharp rise in interest rates. The 12-month Euribor started the year at -0.5% and closed at 3.29%.

Risk premiums went up and not even the highest quality government bonds escaped unscathed. We no longer had any debt with a negative interest rate, and since 1999 we had never had a year with a negative yield on all types of debt, regardless of the risk involved. For example, the Bloomberg Euro Aggregate yield, which tracks investment grade corporate and government bonds, stood at -18.93%, while that of the Bloomberg Pan-European High Yield was of -11.13%.

Central Banks corrected their interest rate policies throughout the year, acting aggressive and quickly to control inflation. The Fed raised rates by 425 basis points, to a range of between 4.25% and 4.5%. The ECB raised rates by 250 basis points, taking the deposit rate from 0.5% to 2%. The Bank of England (BOE) raised rates by 340 basis points to 3.5%.

This also affected the debt of peripheral countries, all of which ended the year with a higher spread vis-à-vis Germany. Italy had the widest spread, ending the year with a spread of 209.54 basis points higher than that of Greece – 206.08 –, the worst at the start of the year.

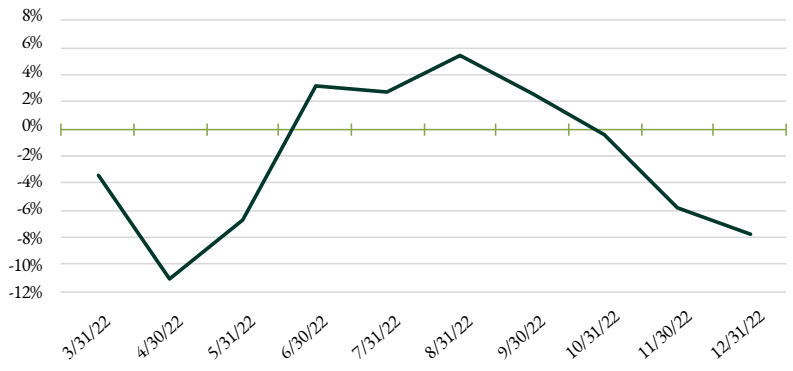
Despite the sharp corrections, the market has already discounted the new hikes expected in the first half of 2023, and these movements are expected to plateau thereafter.

The Fed is expected to raise interest rates three times by 25 basis points each, bringing them to between 5% and 5.25%. The ECB is expected to raise rates by 50 basis points in February and March and 25 basis points in May, taking the rate to 3.25%, while the BOE expects to raise rates by 50 basis points in February and by a further 25 basis points in March and May, bringing the rate to 4.5%.

According to Moody's projections, default rates for high yielders are expected to rise from 2.5% to 4.5% in 2023, but these companies have made a large debt rollover in 2021, reducing their funding needs. On the other hand, their liquidity levels are at their highest since 2017.

2023 could be set to become the 'year of bonds'. Inflation data are showing signs of a turnaround, which is reassuring for central banks. Bonds are already trading at risk premiums not seen for many years, and investment garde and government bonds have been heavily hit and should the asset class of choice this year.

Retail sales in China



Source: Banco Carregosa/Bloomberg

Significant volatility in retail sales was a constant and striking feature of the Chinese economy in 2022, reflecting not only the authorities' "zero Covid" health policy, but also the evolution of Covid-19 cases throughout the year. By the end of the first quarter of 2022, the gradual increase in Covid-19 cases, partly influenced by the Lunar New Year celebrations and increased domestic travel, led to localised lockdowns in major Chinese cities, particular the most populated one, Shanghai, with 25 million inhabitants, and further tightened travel restrictions by the authorities, reinforcing the "Covid zero" policy. This scenario was detrimental to the Chinese economy. However, it gradually improved as the summer approached, the number of Covid -19 cases dropped and the more restrictive rules took effect. By the end of the year, the situation had worsened again, with fears growing that the Chinese Lunar New Year celebrations in 2023 will again affect the world's second-largest economy.

Equity Outlook

The year 2022 saw a paradigm shift in the global macroeconomic environment: from disinflation to inflation, from negative to positive interest rates, globalisation gave way to regionalisation, the era of abundance at low prices ended with scarcity and higher labour and energy prices, low investment gave way to increased public spending financed by debt and greater state intervention, and the issue of growth was replaced by margins. Against this backdrop, most equity indices ended the year with significant double-digit losses.

Commodities were the best performing asset class, while longer duration assets (Nasdaq and growth companies) underperformed. We are witnessing a kind of "revenge of the traditional economy":

1) A reversal between the relative gains of traditional established companies and new entrants in the digital economy. Example: Amazon vs Walmart; 2) A reversal of leadership from tech and growth companies to more traditional and physical industries. Example: Meta vs Exxon.

Despite the narrowing of multiples in global equity markets seen in 2022, valuations still remain vulnerable to rising yields. While it is true that global equities are trading at 14.3x P/E 23E (just below the historical average of the last 20 years), US equities remain expensive in absolute terms at 17.5x P/E 23E and also compared to European equities, which trade at 12.4x.

After the resilience in profits seen in 2022, 2023 may be more challenging for companies. Margins will be squeezed by higher costs of raw materials, labour, interest, and rates.

Developments in the last 3 months

	30-sep	31-oct	30-nov	31-dec	Last 3 months	Last month (dec)
Equity						
SP 500	3 585.62	4 130.29	4 080.11	3 839.50	7.08%	-5.90%
Nasdaq 100	10 971.22	12 947.97	12 030.06	10 939.76	-0.29%	-9.06%
DAX 30	12 114.36	13 484.05	14 397.04	13 923.59	14.93%	-3.29%
Stoxx 600	387.85	438.29	440.04	424.89	9.55%	-3.44%
Nikkei 225	25 937.21	27 801.64	27 968.99	26 094.50	0.61%	-6.70%
Shanghai Composite	3 024.39	3 253.24	3 151.34	3 089.26	2.14%	-1.97%
MSCI World	2 378.65	2 746.37	2 720.89	2 602.69	9.42%	-4.34%
MSCI Emerging	875.79	993.78	972.29	956.38	9.20%	-1.64%
Long-term interest rates						
10-year Yield Treasury	3.83%	2.65%	3.61%	3.87%	4.6 pb	26.9 pb
10-year Yield Bund	2.11%	0.82%	1.93%	2.57%	46.3 pb	64.1 pb
10-year Yield OT Portugal	3.18%	1.84%	2.88%	3.59%	41.1 pb	70.9 pb
Short-term interest rates						
3-month Libor USD	3.75%	2.79%	4.78%	4.77%	101.3 pb	-1.1 pb
3-month Euribor	1.17%	0.23%	1.97%	2.13%	95.9 pb	15.9 pb
3-month Libor GBP	3.34%	1.94%	3.68%	3.87%	52.0 pb	19.1 pb
Exchange						
EUR/USD	0.9802	1.0220	1.0406	1.0705	9.21%	2.87%
EUR/GBP	0.8775	0.8393	0.8630	0.8853	0.89%	2.59%
Commodities						
Brent	80.71	99.62	86.99	85.91	6.44%	-1.24%
WTI	76.63	95.30	80.66	80.26	4.74%	-0.50%
Gold	1 660.61	1 765.94	1 768.52	1 824.02	9.84%	3.14%

In addition, these costs will be more difficult to pass on in a recessionary environment.

The consensus seems to continue to reflect some optimism on margins: although the price of some materials is still very high, prime prices have already eased from their peak, the year-on-year impact is still rising, and in some cases hedging policies will not have an impact until 2023. The weight of the increase in interest rates and taxes for companies also seems to have been underestimated, and labour costs are still rising.

With less reliance on expanding multiples to drive markets (which was the case in a low interest rate environment), the importance of and ability to capitalise on returns over time is more apparent. Quality, sustainability and recurrence of earnings are proving to be more important than the growth of earnings alone.

In this context, selecting companies with strong balance sheets and stable margins remains key. Valuation will continue to be a key factor for investors in 2023. Our preference will be for "growth / quality at a reasonable price" (GARP and QARP) strategies, for Europe (ex-UK) over the US (which we have moved to neutral), but we remain cautions at sector level, favouring more defensive sectors such as consumer goods, health, technology (on a selective basis). We have kept the more cyclical sectors such as manufacturing, discretionary consumption and the automotive industry in a subweight position. The UK remains the least desirable region due to its exposure to commodities, which could see their behaviour reverse in 2023.

Outlook for Alternatives

2022 was a good year for alternative strategies in relative and, in many cases, absolute terms.

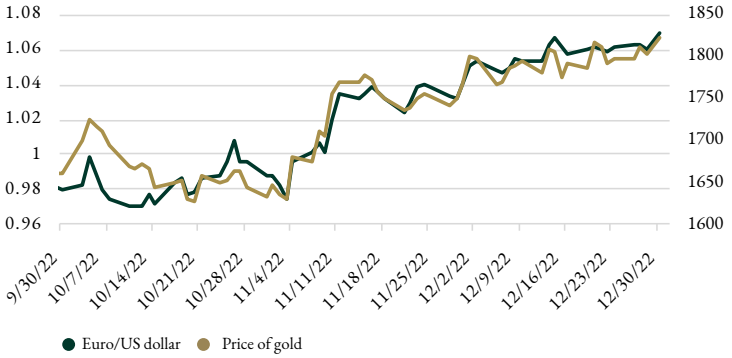
We expect this momentum to continue as the macroeconomic environment is still volatile, market moves are broad-based and de-correlations are on the rise. This bodes well for macro, CTAs and long/short strategies.

With regard to raw materials, energy derived from hydrocarbons is likely to be in an unstable equilibrium. On the one hand, the recession will reduce consumption, on the other hand, supply capacity is limited due to sanctions, low investment (given the energy transition), OPEC+'s interest in keeping the price above €80, and the likely recovery of the Chinese economy.

The performance of gold will depend very much on the Fed's actions. If the Fed abandon a tight policy too soon (before inflation is properly controlled), then gold should perform well. Barring a geopolitical shock, if the Fed succeeds in controlling inflation to its 2% target, gold should gradually depreciate. That said, it is still prudent to maintain some exposure to gold in a multi-asset portfolio.

A global recession would limit opportunities in real assets (e.g. infrastructures). Real estate is likely to continue to feel the difficulties seen in the second half of 2022. Indeed, several international funds have been unable to meet investors' requests to redeem their investment and several hedge funds have favoured "short" positions in REITs.

Exchange market and gold



Source: Banco Carregosa/Bloomberg

Since the start of the last quarter of 2022, the price of gold has rebounded sharply, mainly driven by the weakening of the US dollar. The US dollar has lost ground against the euro as investors perceived a slowdown in the Fed's more hawkish stance, with the US central bank's terminal rate approaching, and found that the ECB is still relatively restrictive. The rally in markets, in particular the equity markets, has also contributed to this weakness in the dollar. This weakness of the North-American currency is taking place in spite of some improvements in the US foreign trade balance, as confirmed by the fall in the trade deficit in November, the latest figure available.

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