

Overview Outlook - Autumn



4th Quarter 2022

Editorial

By the Chief Investment Officer

Inflation and rising interest rates have depressed the value of financial assets. However, we need to go back 15 years to find investment opportunities with such attractive nominal risk-return rates as those today, particularly in terms of financial assets with lower business cycle and credit risk. As global economy faces challenges, the more cyclical components may go through a phase of volatility before undergoing a more sustained recovery, which should reward bolder investors in the medium term.

As we enter the final stage of the year, it is clear that 2022 will go down in history as an adverse year for investors. The world has changed and the value of assets has adjusted to the new reality. Much of what we held as granted has faded away. There is no end in sight for the conflict in Europe, the energy crisis is hindering the energy transition, the globalisation process is facing new threats, and inflation is slow to react to monetary policy attempts to control it. Most financial assets have lost their value in the last 9 months. Safe haven and very low risk assets such as short-term bonds, for e.g. 2-year bonds issued by the German and US governments, have lost roughly 5% since the beginning of the year, in euros and US dollars, respectively. Assets with greater exposure to credit and economic cycle interest rates are showing greater losses.

Past yields are not indicative of future performance, and in the case of short-term bonds of high credit quality issuers this situation should be positive. While 9 months ago a 2-year German bond foretold a negative annual return of -0.6%, today this investment assures an annual return close to +2.0% at maturity. Assets exposed to increased risks currently carry higher risk premiums than those in place in early 2022, although it is debatable whether these are already sufficient to adequately compensate investors in the more challenging environment.

The adverse effects of inflation and interest rates have already been reflected in the financial market and threaten to affect the real economy over the coming months through lower

disposable household income and a recessive or low growth economic environment which, associated with more restrictive monetary conditions, may promote greater volatility in the more cyclical assets before the conditions for a more sustained recovery are met.

From a medium and long term perspective, the appreciation of equity markets no longer seem exaggerated and should allow investors to be remunerated for the increased risks incurred in these assets.

In the equity and credit markets, the selection of robust issuers with strong balance sheets will be key to increasing the probability of success over the coming months, where weaker players may not be able to remain viable.

In an environment that is expected to be challenging, we will seek to take advantage of the investment opportunities with capital and returns guaranteed by high credit quality issuers together with selective exposure to equity markets. We will continue to strictly manage and control the risk level of portfolios.



Mário Carvalho Fernandes

Position

Classes	Subclasses	--	-	Neutral	+	++
Liquidity	Sight deposits, Term Deposits				■	■
	Investment Grade Europe			■	■	
Bonds	Investment Grade USA (EURHdg)			■	■	
	Global High Yield (EURHdg)		■	■		
	Global Emerging (EURHdg)		■	■		
Shares	Europe formerly UK		■	■		
	USA (EURHdg)			■	■	
	United Kingdom (EUR)		■	■		
	Emerging (EUR)		■	■		
Other	Gold, REITS, Infrastructures, etc.				■	

Macroeconomic Analysis

The global economy continues to face considerable challenges, resulting from the lingering effects of three major forces: the invasion of Ukraine by Russia, the cost of living crisis determined by rising and widespread inflationary pressures, and the slowdown of the Chinese economy.

The main European activity indicators, namely the German Ifo and Zew, reflect a sharply slowing economy and the prospect of recession as winter approaches and the energy crisis ramps up. Inflation has not yet shown signs of slowing down in Europe and has reached double digits in some countries, this phenomenon being most visible in the economies most dependent on Russian natural gas. In September, German year-on-year inflation reached 10%. However, high inflation has allowed the consolidation of public accounts in some European economies, creating ‘cushions’ capable of responding to a possible worsening of the economic crisis in the coming quarters. External accounts continue to deteriorate, heavily affected by Europe’s dependence on external sources of fossil fuels. The labour market, however, remains relatively resilient. The German unemployment rate rose only 0.1 percentage points in the third quarter to 5.5% in September. Activity indicators, on the other hand, measured by PMIs and consumer sentiment continue to deteriorate in Europe, corroborating a recession scenario later this year or in 2023.



Along with the energy crisis in Europe, the intensification of the European Central Bank's (ECB) aggressive stance has also increased the risk of a recession.

In the US, despite a slight slowdown in inflation as a result of lower fossil fuel prices, the Consumer Price Index figures, excluding food and energy, remain high and close to 40-year highs. But the labour market remains resilient and the unemployment rate fell to 3.5% in September. Job offers remain high and outweigh the number of US unemployed by 1.7, sustaining the rise in salaries and reinforcing the contractionary behaviour of the US Federal Reserve's (Fed) monetary policy, contributing to an economic slowdown that could culminate in a recession. However, in September wage growth slowed to 5% year-on-year.

The US balance deficit has improved and external accounts should contribute to a recovery in output in the third quarter, following a contraction in the economy in the first half of the year. The Atlanta Fed's GDP Now anticipates US GDP growth of 2.9% in the third quarter.

Futures linked to Fed interest rates traded on the Chicago derivatives exchange anticipate a rise of 75 basis points at the next meeting on 2 November, with an 80% probability, and a rise of at least another basis point, with a 91% probability, at the last meeting on 14 December, closing the year between 4.25% and 4.50%.

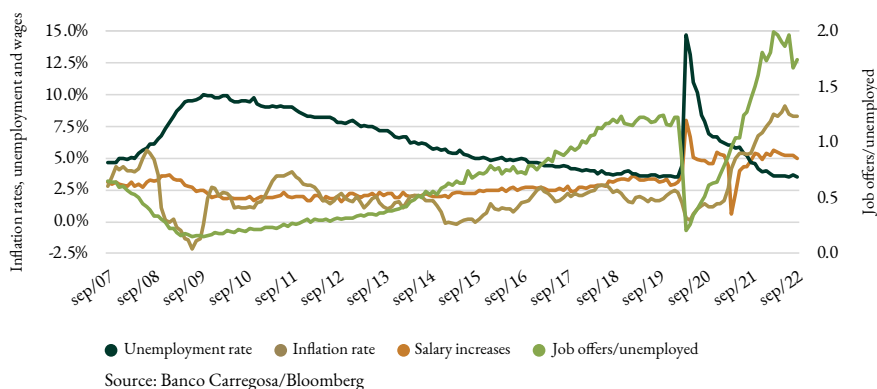
In China, the successive localised lockdowns dictated by the 'Zero Covid' policy have penalised the world's second largest economy, especially in the second quarter of 2022.

In addition, the real estate sector, representing about one-fifth of Chinese economic activity, has markedly slowed down. As such, and given the significant size of the Chinese economy, roughly 18% of world GDP in 2021, and its importance to global supply chains, international trade has been penalised and the pace of globalisation tends to slow down, a growing reality since the first pandemic lockdown in the spring of 2020, accelerated by the war in Ukraine. Indeed, the pandemic and the war in Ukraine have substantially shaped the world and the economy.

The IMF estimates that more than a third of the global economy will enter recession this year or next year, while the three largest economies, the US, European Union and China, will continue to slow down. The IMF notes in its October report that "the worst is yet to come, and for many people 2023 will look like a recession."



Employment, Salaries and Inflation in the US



The ratio between job offers and the number of unemployed in the US is inversely proportional to the employment rate, but is directly related to the wage bill. When the ratio falls, either because of a decrease in job offers by companies or because of an increase in the number of unemployed people, the claiming power of wage earners tends to decrease and the unemployment rate tends to increase, and vice-versa. This is how the law of supply and demand works in the job market, as indicated in the chart. As long as the US job market remains resilient, and job offers substantially outnumber the unemployed, the Fed is likely to maintain the interest rate hike, as Powell has pointed out. Only a significant slowdown in the inflation rate would reverse the stance of the US central bank. In recent months, albeit slightly, both wage growth and the inflation rate have declined.

Bond Market

The conflict in Ukraine has caused more disruptions and there is still no end in sight. High inflation has forced more abrupt adjustments in interest rates and Central Banks continue to chase losses by raising rates rapidly and in some cases making moves not seen in decades.

In September the Fed raised rates by 75 bp to 3.25%, the Bank of England by 50 bp to 2.25%, the Swiss National Bank by 75 bp to 0.50% (leaving negative ground), the Swedish Central Bank by 100 bp to 1.75% (the most aggressive move in 3 decades), and the Norwegian Central Bank by 50 bp to 2.25%.

The rise in rates is expected to continue until 2023, when it is expected to stabilise. The Bank of Norway has already detected signs of response from the economy in the fight against inflation, and estimates that rates should peak in the third quarter of 2023, at 3.11%.

Christine Lagarde states that the ECB will continue the rate hike and that their objective is to stabilise prices and not to cause a recession. The current ECB rate is 0.75% and we should see a further rise at the meeting on 27 October, with the ECB estimating that the neutral rate should be between 1% and 2%, a level at which it neither stimulates nor restrains the economy.

At the Jackson Hole meeting, Jerome Powel made it clear that recession is a characteristic and not an imperfection in the adjustment process to control inflation.

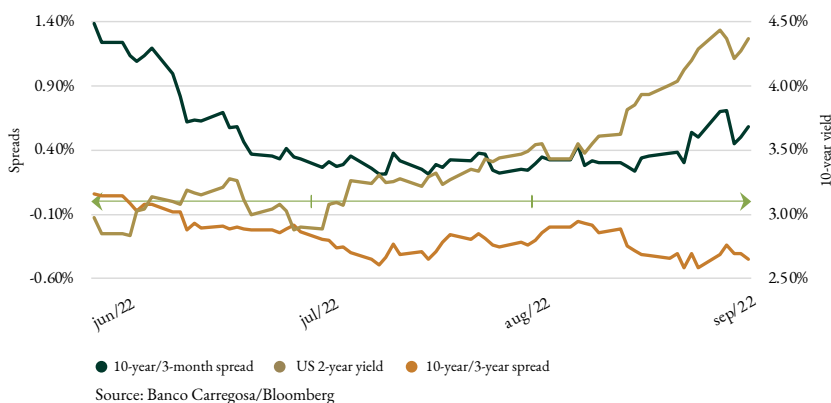
All these factors have contributed to the current inversion we are seeing in the interest rate curves of the core sovereign debt. The 3-year Treasury rate stands at 4.3%, while that of the 10-year Treasury is of 3.92%, showing that the market believes in the normalisation of interest rates and inflation over time.

Bond prices have fallen across the board, regardless of maturity and credit quality, bringing the current bond market return more in line with the expected long-term equity market return.

These movements create opportunities and at the moment the Investment grade debt offers yields above 4% in the US and close to 4% in Europe. The US High Yield debt shows yields above 8%, and European debt is approaching that level.

Short-term credit quality up to 3 years is positive. In High Yield, careful selection is recommended to avoid issuers with less resilient balance sheets. When inflation shows signs of abating, value may be found in longer maturity bonds.

Interest rates and US yield curve



The yield on the 2-year US treasury bond has been gradually rising and increased to 4.3% at the end of September, from 2.95% in early July. This increase reflects the Fed's increasingly restrictive monetary policy and the successive 75 basis point increases in interest rates at each FOMC meeting, aimed at curbing the highest inflation in the last 40 years. The increase in interest rates tries to adjust the current demand for goods and services, but this increasingly 'aggressive' Fed stance could culminate in a recession. The Fed's September quarterly outlook worsened substantially from June, corroborating a scenario of a sharp economic slowdown, reflected in an upward revision of projections for the unemployment rate from 3.9% to 4.4% in 2023. The 10- to 2-year spread confirming a more than 12 month recession and the 10-year and 3-month spread were close to indicating a recession in mid August.

Equity Outlook

The third quarter reflected market volatility: July was off to a strong start, August was resilient up to the last week (coinciding with Jackson Hole), and September was a risk-off month.

The results period, mostly between July and August, were mainly responsible for the resilience in the markets. Profit warnings were scarce and numbers even exceeded analysts' estimates, both in the US and in Europe.

Valuations have already adjusted considerably with the falls seen in equities so far. The European market is at around 10.4x for the FY22 P/E, i.e. 5 points below its historical average. The P/E for the S&P 500 later this year has also contracted from 21x to 15.8x.

Despite this derating in valuations, the expected fall in companies' cash flows/future profits does not yet seem to be fully corrected in the market. Analysts very timidly revised their numbers downwards, especially after the first year-half was better than anticipated.

Consensus estimates in terms of margins and profits still suggest an expansion: profit growth of 8% and 6%, in 2022 and 2023, respectively for S&P 500 companies, and 18.5% and 3.3% for Stoxx 600 companies. Note that, on average, earnings per share in Europe have fallen by 29% in the last 5 recessions. In 2001, a 'mild' recession, this metric dropped fell by 11%.

Still, some aspects remain favourable: demand for labour remains strong, households continue to have excessive savings,

Developments in the last 34 months

	30-jun	31-jul	31-aug	30-sep	Last 3 months	Last month (sep)
Equity						
S&P 500	3 785.38	4 130.29	3 955.00	3 585.62	-5.28%	-9.34%
Nasdaq 100	11 503.72	12 947.97	12 272.03	10 971.22	-4.63%	-10.60%
DAX 40	12 783.77	13 484.05	12 834.96	12 114.36	-5.24%	-5.61%
Stoxx 600	407.20	438.29	415.12	387.85	-4.75%	-6.57%
Nikkei 225	26 393.04	27 801.64	28 091.53	25 937.21	-1.73%	-7.67%
Shanghai Composite	3 398.62	3 253.24	3 202.14	3 024.39	-11.01%	-5.55%
MSCI World	2 546.19	2 746.37	2 627.32	2 378.65	-6.58%	-9.46%
MSCI Emerging	1 000.67	993.78	994.11	875.79	-12.48%	-11.90%
Long-term interest rates						
Yield Treasury 10 yr	3.01%	2.65%	3.19%	3.83%	81.6 pb	63.6 pb
Yield Bund 10 yr	1.34%	0.82%	1.54%	2.11%	77.2 pb	56.7 pb
Yield OT Portugal 10 yr	2.42%	1.84%	2.63%	3.18%	76.0 pb	54.7 pb
Short-term interest rates						
3-month USD Libor	2.29%	2.79%	3.10%	3.75%	147.0 pb	65.5 pb
3-month Euribor	-0.20%	0.23%	0.65%	1.17%	136.8 pb	51.9 pb
3-month JPY Libor	1.67%	1.94%	2.53%	3.34%	167.5 pb	81.0 pb
Exchange						
EUR/USD	1.0484	1.0220	1.0054	0.9802	-6.51%	-2.51%
EUR/GBP	0.8609	0.8393	0.8651	0.8775	1.93%	1.44%
Commodities						
Brent	100.58	99.62	94.21	85.14	-15.35%	-9.63%
WTI	97.75	95.30	89.03	79.49	-18.68%	-10.72%
Gold	1 807.27	1 765.94	1 711.04	1 660.61	-8.12%	-2.95%

Outlook for Alternatives

a good number of companies have not built excess capacity or disproportionate inventories, governments are increasing public investment, and most financial institutions remain healthy.

Although each cycle is different, history has shown us that rate cuts, or at least expectations of cuts, seem to coincide with market lows. The question that needs asking is whether at the end of this year we will be facing the last interest rate hikes.

In this context of vulnerability and geopolitical uncertainty, we continue to favour a more defensive (and less cyclical) position, where selection remains critical: we continue to prioritise healthy companies that have sound balance sheets, that generate cash flows, are profitable and growing, have low labour intensity, and have pricing power. The US and Switzerland continue to be our preferred geographies. We believe that the most affected geographies will be those that will suffer the most from the energy shock (EU and the UK), while a recession in the US could be milder.

In terms of sectors, our preference continues to be current consumption and health, typically defensive, and in technology we prioritise ‘mega/big caps’. In this context, the less preferred continue to be discretionary consumption and industry, with tourism and leisure also moving to this sector. Banking could benefit from the cycle of rate hikes, so we assume a neutral exposure to the sector.

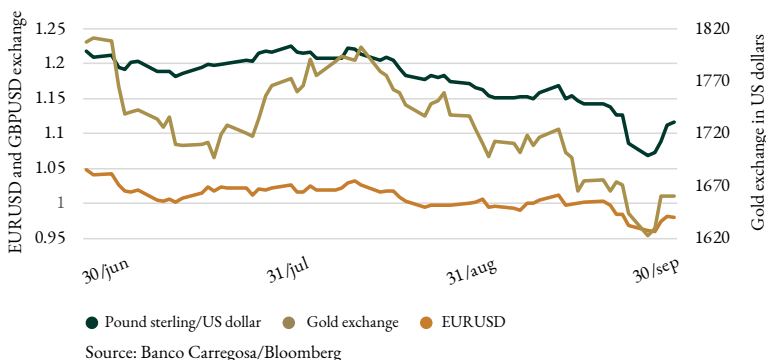
The inflationary pressure in the last quarter (CPI All Urban Consumers) in the US dropped from a 9.1% high in June to 8.2% in August. However, these figures remain too high for the Fed’s – with identical scenarios for Europe and the UK. Thus a restrictive monetary policy is expected to remain in place (impacting economic growth).

The cross-current context of reduced growth, high inflation and lower market liquidity has been particularly favourable for macro funds. It should be noted that these funds had a ‘near-death’ experience from 2012 to 2017 due to the one-way markets resulting from the Quantitative Easing programmes. The year was also positive for investment in infrastructures in various ways:

- i) real assets tend to perform positively in inflation conditions;
- ii) indirect exposure to some energy commodities; and
- iii) real pricing power. In this sense, we maintain our preference for the infrastructure sector over real estate, as we expect a rising vacancy rate as the economic environment worsens.

We believe that gold could continue to play a decisive role because: i) throughout history it has proven to be a safe haven asset in geopolitical conflict contexts, and the ongoing conflict could still get worse; and ii) gold should benefit the most if the Fed considers that recession is a bigger problem than inflation, reducing its restrictive level, a scenario that seems more likely than perceived by the market.

Exchange market and gold



The US dollar in the third quarter strengthened its hegemony in the foreign exchange market. The growing spread between the US dollar and euro interest and the intensification of the energy crisis in the euro area have contributed to a devaluation of the single currency. The pound sterling continues to be penalised by high inflation and the strong economic slowdown, trends without any end in sight, as well as by the unfavourable interest rate spread against the dollar. The difficulties in understanding the financing of the British ‘mini-budget’ have also penalised the pound. The financial market downturns have aroused investors’ appetite for safe havens, and the US dollar has emerged in this particular case as the main safe haven asset amidst growing uncertainty and volatility. The appreciation of the US currency and the growing rise in the US dollar interest rate have taken the shine off gold, a precious metal that does not generate any income other than capital gains, thus making it unattractive even in an inflationary context.



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