BELVÉDÈRE
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BUT THIS TIME IT'S DIFFERENT

MARKET INSIGHTS

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How many times have you heard someone say, "but this time it's different"? Usually it is an attempt to justify an extraordinary, often incongruously favourable market development amid flashing amber lights. The dotcom bubble around the turn of the millennium is one example, when the then exuberant valuations were justified with the New Economy phenomenon and its purportedly infinite possibilities.

Most of the time, however, things are not different at all. Excessive valuations and a (too) euphoric mood are no reason for prices to soar even higher. Persistent geopolitical uncertainties affecting the economic and financial centres do not, as a rule, boost stock markets. Equity prices do not benefit from rapidly rising long-term interest rates, especially if the rate hikes are not due to an economic upswing but a response to rampant inflation. Central banks that pursue a more restrictive policy by raising key interest rates and absorbing liquidity adversely affect markets. So does the combination of a foreseeable economic downturn and poor corporate results. This may not necessarily apply in each individual case, but generally it does and we see a most ostentatious display of it this year.

Yet, this time it actually is different than usual, and for two particular reasons. To begin with, the aforementioned events have all been unfolding simultaneously for several months now, which in itself is extraordinary. But also, for once, even central banks cannot be relied on for a remedy. I have been in the markets for almost 30 years and I can hardly remember a time when monetary authorities would have chosen not to give markets a hand in a situation similar to the one we are experiencing right now. This is by no means a call for central banks to reopen the liquidity floodgates. The so-called central bank put, i.e. the certainty that the monetary watchdogs would intervene quickly if worse came to worst or perhaps even preventatively, is part of today's problem. Still, it is quite remarkable that they are not willing or able to intervene at present.

So, where does this take us? Equity markets can currently neither expect support from the economy, nor from interest rates, and not from geopolitics either. True, most of this is already reflected in the prices. But there is currently no trigger for a sustained recovery. And the upcoming reporting season could once again prove a real challenge (see equities section). After all – and this may seem an odd thing to say – the mood on the stock markets is quite terrible. This could imply that the selling pressure is easing, as those who intended to sell would have done so by now. Or perhaps this time it just might be the same as usual: when push comes to shove, the central banks will rush in, as the Bank of England has already done recently (this time, though, indeed for good reason). The European Central Bank's (ECB) recently introduced Transmission Protection Instrument (TPI) is ready to be deployed. Let's see what happens next.

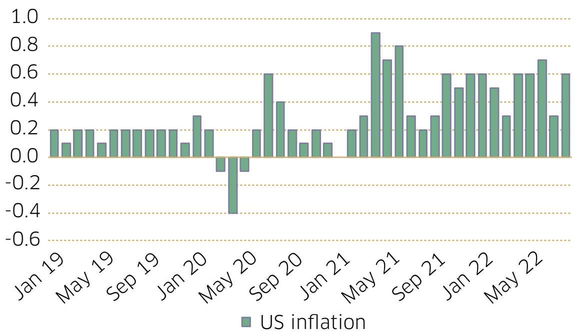
Thomas Heller
CIO, Belvédère Asset Management

ECONOMY

The US economy continues to hold up fairly well. The manufacturing Purchasing Managers' Index (PMI) remained above the growth threshold of 50 points in September and private consumption rose slightly in August. Corporate investment activity also remained robust. Higher interest rates are beginning to make a dent in the cyclical construction sector, though. But, the more the US Federal Reserve (Fed) tightens its monetary policy, the greater the risk of an adverse effect on other areas of the economy. The Fed has every reason to raise rates further, as inflation accelerated suddenly in August (core rate of 0.6 %, compared to 0.3 % in the prior month). We do not yet see a recession in the US, but the risks have definitely increased.

Until recently, the euro zone economy benefited from catch-up effects (services, travel). These positive effects have substantially diminished, while inflation keeps rising (10.0 % in September) and eating away at consumers' purchasing power. Manufacturing is still struggling with capacity bottlenecks and most of all with higher energy prices. The respective PMI is below 50 points again for the second consecutive month. The euro zone is heading for a recession. What remains to be seen is the extent of the downturn and how long it will last, both of which will ultimately depend on the availability of energy.

US inflation (core rate) in %, compared to prior month



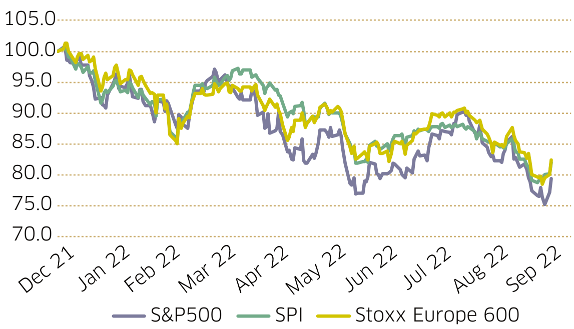
Source: Bloomberg, BAM

EQUITIES

Equity markets launched into September on a confident note, but were abruptly brought down to earth by a much higher inflation rate than expected in the US. Over the month, indices lost 6% to 10%, with growth stocks taking the hardest blows. In the meantime, however, many negative factors – such as a poor economy or escalation in the Ukraine conflict – have most likely been priced in. Moreover, the mood among investors is very downcast. According to surveys, the share of optimistic investors in the US is at a very low 20 %. It is therefore quite possible that there will be a rebound after the heavy losses.

However, the upcoming reporting season could cloud the picture again quickly. Analysts have already revised their earnings estimates for the S&P500 for the third quarter downwards by more than 6 %, but these companies' outlook is unlikely to be too bright, in view of the poor economy. If we look at Nike, for instance: the American sporting goods manufacturer is suffering from high inventories and consumer restraint, which led to a stock correction by over 12 %. Interest rates are also slowing stock markets down. For the first time in years, investors have again a real alternative to equities to choose from.

Equity markets year-to-date (indexed)

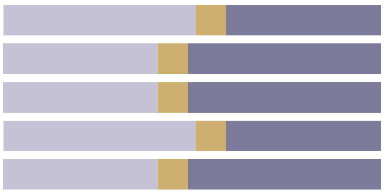


Source: Bloomberg, BAM

INTEREST RATES

The uncommonly large swings in capital market yields persist. The rise in interest rates we saw since mid-August continued seamlessly in September and in the US and Europe the peaks of June were exceeded (contrary to our own expectations). In Switzerland, interest rates moved within the expected range. US interest rates have risen sharply due to the surprisingly high inflation and the Fed's determination to push through as many interest rate hikes as necessary to achieve price stability.

UK bonds experienced an even stronger rise in interest rates after the new government under Liz Truss announced tax cuts. The bond market became so unhinged that the Bank of England had to stabilise the long end of the yield curve with unlimited purchases, which then also led to an easing in all other fixed-income markets. For the short term, we believe the worst is behind us, but whether new peaks are looming further down the line depends largely on the future course of inflation. We expect the Fed to raise rates again at its next two meetings by 75 and 50 basis points respectively. Given the higher inflation, the ECB and the Swiss National Bank will not be able to avoid further interest rate hikes, either.

Asset class	Appraisal	Commentary
Bonds Government bonds Corporate bonds		Inflation is high and more obstinate than expected, forcing central banks to raise interest rates further. At the long end, we have come through the worst of it for the time being.
Equities Switzerland Eurozone United Kingdom US Emerging markets		Prices have probably overshot on the downside in the short term and may bounce back. However, the coming reporting season may yet have some negative surprises in store.
Real Estate Switzerland		Rising interest rates have had a negative effect on real estate investments. Valuations have declined significantly and are not unattractive at these levels.
Commodities Oil Gold		Gold was under pressure despite heavy market turbulence due to higher interest rates and a strong US dollar. The oil price should stabilise due to OPEC's planned production cut.

unattractive — attractive ■ Current asset class assessment

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