BELVÉDÈRE
Asset Management

December 2022

EMOTIONAL AND EFFICIENT

MARKET INSIGHTS

EMOTIONAL AND EFFICIENT

The US stock market (in terms of the S&P 500) fluctuated by more than +/– 2% about once a week on average so far in 2022. This is slightly more than in the corona year 2020 and significantly more than in ordinary years. In 2019 and 2021 this only happened on seven days each, and in 2017 on none at all. Of course, there are reasons for the increased swings: the war in Ukraine, inflation, interest rate hikes, to name but a few. Nevertheless, it seems that markets are not always rational. Investors may sometimes also be driven by emotions. This (obvious?) insight has merited a Nobel Prize in economics more than once. Most recently in 2017, by the American Richard Thaler for his research in the field of behavioural economics.

Emotions are not included in the theory of efficient markets, though. The efficient market hypothesis (EMH) argues that the price of a security reflects all the information that is available in the market. This also implies the assumption that market participants act rationally, information is readily available to everyone and this is immediately and correctly reflected in the pricing process. The result being a consistently and invariably rational homo economicus. This notion, too, has been rewarded with a Nobel Prize. Are markets now rational and efficient or are they irrational and inefficient? In 2013, Eugene Fama, an advocate of rational markets, and his ideological opponent Robert Shiller, two economists with contrary positions, both received the Nobel Prize in the same year, which only goes to show that the truth resides probably somewhere in between.

“Tea or coffee?” “Tea please.” “We also serve punch.” “In that case, I’ll have some coffee.” Such behaviour is irrational. It makes no sense to change the order of preference of tea and coffee just because the option of punch is added. Do financial markets actually behave this way? This would mean that investors are acting against their own better judgement. Surely, that is rather an exception than the rule. Normally, investors do act rationally, at least to some extent. They act based on economic deliberations and place only so many resources into their investment decisions as seems reasonable from a cost-benefit perspective. This can lead to misinterpretations and (in retrospect) to some evident exaggerations. This is not irrational, even though – strictly according to the EMH – it is inefficient.

Then again, it would be going too far to conclude that markets are inefficient simply because not all participants have ready access to information and do not process it immediately and correctly. Still, investors do make mistakes in judgement and implementation. Consequently, behavioural economics quite rightly assumes that the preconditions of EMH are not (always) given and that emotions have a material impact on our behaviour. But, this does not make the markets a playground of a bunch of irrational market participants and a place of widespread inefficiency.

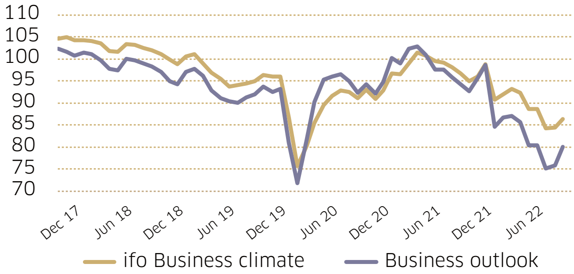
Thomas Heller
CIO, Belvédère Asset Management

ECONOMY

The US economy is holding up better than expected. Although the housing market is clearly suffering from rising interest rates, retail sales and business investment turned out better than expected in October. Moreover, there are signs that inflation may be easing. Consumer price index rose 7.7% for the month ending October, a much slower pace than expected. Data reveal that for many products inflation had peaked out. According to the purchasing managers' survey, industrial output in the euro zone declined further in November. Many companies are struggling with high prices for energy and materials. On the positive side, gas storage facilities are well stocked in all EU countries, which should allow them to get through the winter without rationing, if temperatures stay within the normal range. This makes the situation less dire than feared a few months ago, and there is even a glimpse of hope for the spring: The latest ifo business climate index shows that German companies are more optimistic about the future for the first time in a long time.

Let's take a look at China. So far, 2022 has been marked by a restrictive corona policy, which led to stagnation in private consumption and disrupted supply chains. Foreign companies are therefore rethinking their investment plans in China. The government is facing a major challenge of loosening policies without risking a sudden surge in death tolls. One of the key measures will be to achieve a higher vaccination rate among the elderly population. We expect the zero-covid policy to end in March and the economy to recover as a result.

Pessimism has bottomed out
Index levels, 2015 = 100

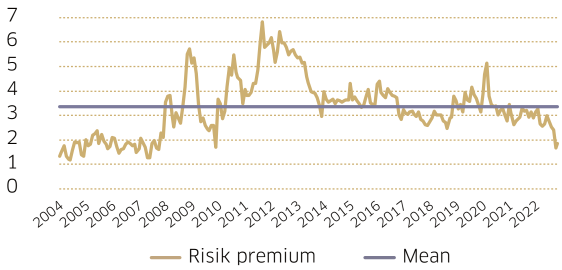


Source: Bloomberg, BAM

EQUITIES

Equity markets continued to recover in November. The main drivers were easing inflation and the associated hope for an imminent end to the central banks' interest rate hikes. In Europe, markets also benefited from surprisingly bright third-quarter corporate results. Earnings increased overall by more than 33% this year to date compared to the previous year, and by 13.5% excluding the energy sector. As a result, the Euro Stoxx index rose by 8.1%, thus outperforming the S&P 500 (+5.6%). What is the earnings outlook though for the coming quarters? With the slack economy or even a slight recession in Europe, companies have hardly any tailwind from the demand side for further increases in sales and profits. At best, companies that manage to cut costs quickly have the potential for better profits. Overall, the consensus expectation for earnings growth in 2023 for the US and Europe is in the low single digits. Meanwhile, valuations are not particularly attractive and – notably in the US – risk premiums are very low compared to government bonds. In other words, bonds have become a viable investment alternative to equities. In a nutshell, the potential for further price gains in the current environment is limited and – following the good performance in the last two months – we may even see a setback.

S&P 500 with low risk premium
Risk premium (in %) = Earnings yield – 10y interest

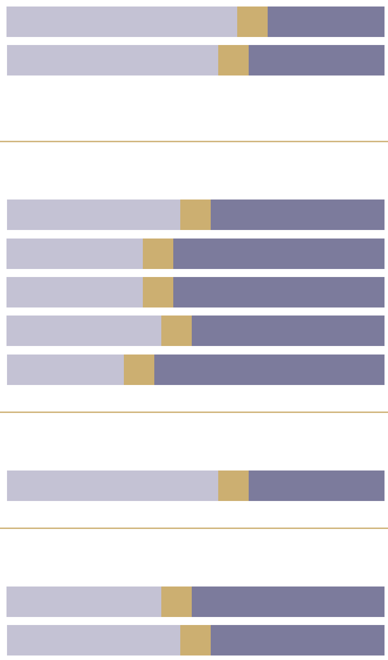


Source: Bloomberg, BAM

INTEREST RATES

In November, interest rates continued to trend slightly downward at the long end. To a certain extent, this was surely owed to the aforementioned easing of inflation in the US. An additional factor may have been the oil price drop of around 10% in November to USD 85 per barrel. We assume that inflation will tend to decline further over the coming months, which might limit the upward pressure on long interest rates. However, a very rapid decline in US inflation – to, say, 2.5% or even 2.0% – is unlikely. The US Federal Reserve has taken note of the recent inflation decline and, according to the latest meeting minutes, the committee is coming to believe that interest rates will soon have reached the target level. Consequently, we expect a hike of only 50 basis points in December and not more than one or two smaller steps of 25 basis points each at the beginning of next year. We also expect to see rate hikes of 50 basis points from the European Central Bank and the Swiss National Bank (SNB) in December. After that, the pressure on the SNB for further rate hikes will diminish, as inflation in Switzerland is evolving along more moderate lines than in the eurozone.

Asset class	Appraisal	Commentary
Bonds		The easing in inflation allows central banks to end the rate hike cycle soon. There is only limited potential for higher interest rates at the long end.
Government bonds		
Corporate bonds		
Equities		Stock markets continued their upward trend. European markets performed surprisingly well. Upside potential is now limited.
Switzerland		
Eurozone		
United Kingdom		
US		
Emerging markets		
Real Estate		Real estate investments consolidated their gains and remain valued comparatively low.
Switzerland		
Commodities		Gold benefited from the easing of interest rates. The oil price is caught between economic fears, OPEC policy and the EU's embargo on Russian oil.
Oil		
Gold		



unattractive attractive ■ Current asset class assessment

Imprint

Belvédère Asset Management AG
info@belvedere-am.com | www.belvedere-am.com