QUARTERLY COMPASS

Q3 2023

KEY CALLS

Cyclical rebound a possibility delaying recession

Lengthen core duration to neutral in the US, not in Europe

European equities remain overweight

Favour "uncorrelated" hedge funds

GLOBAL MACRO AND ASSET ALLOCATION

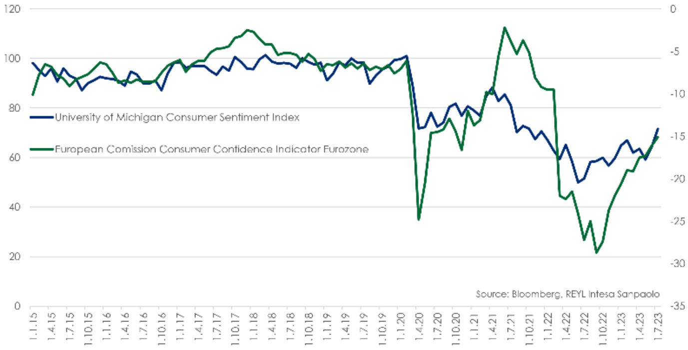
Major economies remain in a trend of slowing growth, despite recent signs of improvement. This cycle has not been typical, exacerbated by the COVID pandemic crisis and its aftermath, as well as induced hyper-aggressive monetary and fiscal policies. Elevated excess savings accumulated during the pandemic have helped households weather the crisis, and now the strength of the job market, decelerating inflation and rising wages seem to be underpinning consumption again.

We could therefore see the emergence of a mini cyclical rebound over the next few quarters. In addition, the huge amount of liquidity still available in the system is acting as a buffer against the interest rate hiking cycle, which may have to be extended to be really effective. Adverse forces are still at play, but slow to filter through: tighter lending standards and rising default rates, as well as less generous fiscal policies. So far, we see no evidence of a full-fledged recession, but we still believe a contraction phase will come and is needed to rebalance supply/demand fundamentals and pave the way for a new economic cycle, likely not before 2024. We don't think the worst is behind us, but we have bought some time. Our view is that the cycle is likely to be "killed" by a policy mistake, as inflationary pressures will require further tightening to be defeated.

Most economists still don't see a global recession, with a soft landing remaining the favoured scenario. At the same time, in the Eurozone, a technical recession is already there, with two negative quarters of GDP growth (Q4 '22 and Q1 '23), at -0.1% each. Inflation continues to abate, but the stickiness of the core measures and their absolute levels remain a problem. The strength (and imbalances) of the job market are supporting wage growth, which is running at levels far above the historical average. Wage inflation remains rock solid (5.6% in the US and 4.3% in Europe). This in turn supports households' consumption, with salaries also rising in real terms. All of this is positive for growth and may support the case for a soft-landing scenario; but we are doubtful that could happen without reviving inflationary pressures. Despite some signs of the job market softening, the unemployment rate needs to rise significantly from here to curb demand and make sure there is no risk of a wage price spiral.

Consumer confidence is on the rise again, and the propensity to consume seems intact. We expect this to be reflected in retail sales actual data in due course, with the potential to boost manufacturing and industrial production, sectors that have been weak compared to the service industry. Advanced indicators like the ISM manufacturing PMI ratio of new orders / inventories are also encouraging. In addition, inventories remained high last year, but have started to decline to the point where the ISM business customers inventories index is now reported as being too low. This may result in some restocking, a positive for future production. If this is the case, it will be an additional source of support for the job market as firms are reluctant to lay off employees when production increases.

Consumer Confidence



Another sector that might support growth is real estate. It is one of the most sensitive to interest rate cycles, usually the first to drop, but also a leading indicator of economic recovery; several US housing market indicators have troughed and now show a rebound. This is the case even though mortgage rates have doubled since 2020. Signs of growth are already visible in economic surprise indices; again, the key variable here for the sustainability of a rebound is job market strength.

Despite the continued reduction of central banks' liquidity, it has been less severe than in 2022. Liquidity remains clearly abundant, with the size of combined balance sheets of the 3 main central banks still 60% above pre-Covid levels. Without a more aggressive liquidity withdrawal, risky assets should remain well supported by the abundance of money available.

Is this "Goldilocks" scenario credible? We fear not, as we don't believe such a full employment environment is compatible with a sustainable downwards path for inflation. Without a more meaningful rise in unemployment, wage inflation might not abate and there is even a risk of global inflation picking up again if energy and commodity prices make a comeback after this year's decline.

What next? It will all depend on when financial conditions become tight enough to impact firms and the consumer. We don't believe we are there yet. Central Bank decisions will be the decisive factor from here. They have two choices: 1. stop their hiking cycle and embark on a long plateau strategy, biding their time and waiting for monetary tightening to have an effect on the economy or 2. continue to hike and taper excess liquidity to curb activity and demand further, until the market "tells" them to stop, and then devise a pivot strategy. We feel it might be too early to stop now in order to decisively defeat inflation, given that monetary authorities have all the tools to stimulate again if needed. The first option carries the risk of overheating the economy later in 2024.

EQUITIES

A business cycle always begins with a recovery and ends with a recession. Since the start of the year, equities have been behaving as if we were in a recovery phase. In the US, for example, cyclical sectors such as consumer discretionary and technology are posting returns of over 30%, while defensive sectors such as healthcare and consumer staples are posting negative returns. Contrary to what the market might suggest, we do not believe that we are in a sustainable economic recovery, or in a new cycle that on average lasts over 6 years. We think we are at the end of a very long business cycle that began during the Global Financial Crisis and is bound to end in a recession sooner or later (COVID was just a "blip", not the end of the cycle).

After three quarters of falling earnings in the US, we have seen growth again in the 1st quarter. This challenges our profit recession scenario. Some might think that the worst is behind us. However, this increase can be explained by several factors.

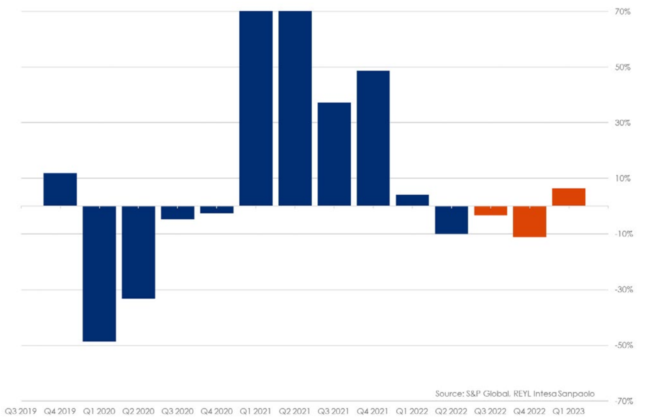
- One, companies, even those that do not usually have pricing power, managed to raise their prices in line with or beyond inflation levels due to historically high consumer savings.

- Two, wages rose slower than consumer goods and services.

- Three, commodities fell by more than 15% in the 1st quarter of 2023 compared to the 1st quarter of 2022.

These three factors contributed to the rebound in profit margins, delaying the recession. Indeed, before we enter the recession, we must first see a fall in profit margins. Falling margins will lead to layoffs and thus an accelerated decline in consumption. This process will take time, at least a few quarters.

Year-on-Year change of the last reported earnings of the S&P 500



In the meantime, cyclical sectors could benefit from the end of the cycle until the market anticipates the coming recession. So, in the short term (let's say less than 9 months), we like some cyclical sectors such as industrials and consumer discretionary. Furthermore, in the past we have repeatedly said that we would be ready to return to a positive stance on equities if at least one of these three things happen:

- The FED pivots;
- Leading indicators turn around;
- Market capitulation.

Recently, leading indicators in the US have turned upwards. We are therefore ready to increase our equity exposure to reach our neutral point, should the market give us a buy signal.

Sell-side analysts are now optimistic. They expect very strong earnings growth of over 11% in the next twelve months. Moreover, the bull/bear ratio which reflects the sentiment of investors towards the stock market over the next six months is high, now at the same level as in 2021. So, in a nutshell, after the strong rebound in prices we have seen, the rise in analysts' expectations and the sentiment of investors, there is downside potential in the event of disappointment. If this drop were to materialize, we would increase our equity exposure. The 2nd quarter earnings season, which has just begun, should give us the opportunity to refine our conviction. In terms of style, we continue to favour quality companies with a high market capitalisation.

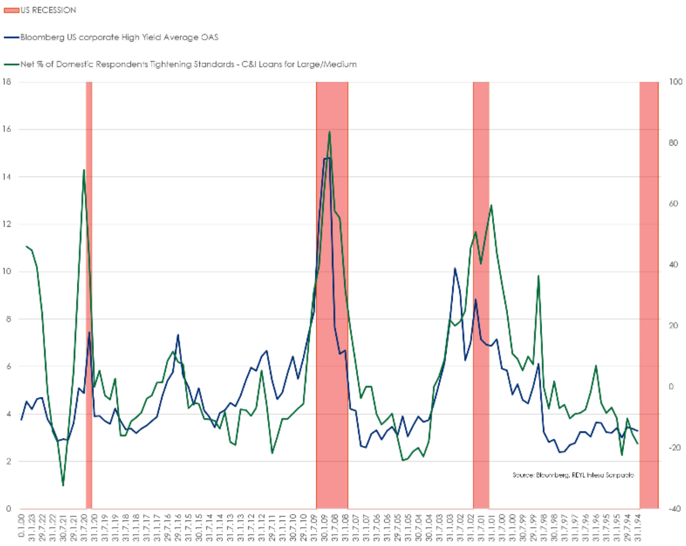
The valuation gap between Europe and other regions of the world is such that we are maintaining our overweight in Europe. Regarding emerging markets, we know that these economies enjoy an economic growth premium over those of developed markets. There are reasons to expect even higher economic growth premiums going forward as China (30% of the index) is likely to enter a period of economic recovery beginning in the latter half of 2023. Until we have confirmation of recovery in China, we remain neutral on emerging markets. And finally, we remain underweight the Japanese equity market.

FIXED INCOME

Considering core government yields, we have recently reached our 10y US Treasury Note yield target zone (3.75%-4%) and consequently lengthened our duration to neutral by buying some 10-year government bonds. The top of this yield generally precedes the one of Fed Fund and occurs around the second-to-last rate hike. The top was reached in October 2022, followed by 5 hikes (!) so it was a false signal, then we saw 3 re-tests of the >4% area in March 2023 (followed by 2 hikes), in July and again this month. The hiking cycle may end soon, hence the duration increase. Still, as further tightening is possible if inflation is not decisively entrenched, which we fear may be the case, we keep our curve flattening position with a 30Y duration exposure and refrain from adopting an outright long duration stance. Think about the 1979-1981 cycle! In Europe, we remain underweight as more hikes will likely be needed.

The credit market has remained really resilient, with spreads tightening markedly this year especially in a high-beta segment like high yield. Higher refinancing costs are a clear threat here, but hopefully companies have been able to lock very low debt yields and extend maturities during the long zero to negative interest rates period. Consequently, the "maturity wall" will not materialize before 2025-2026, giving them some time to breathe. This is less the case for investment grade rated companies, but the robustness of their balance sheets leaves them is good shape to absorb the shock. We continue to favour short-dated investment grade bonds, whose yields are attractive, protecting against negative total returns. Still, similar yields across maturities (the inverted core yield curve effect) do not suggest taking some spread duration risk now with depressed term premia. Spread levels are indeed not so generous, especially if we foresee a deterioration of the economic climate in 2024. The strong tightening of lending standards in the US will impact the high yield corporate segment first, despite depending on the urgency of refinancing needs. The segment's current spread level is too tight to reflect both this risk as well as the possibility of a coming cyclical downturn. We therefore refrain from adding some high yield exposure despite some more tactical upside in the short run being possible.

US Corporate High Yield and Tightening of Lending Standards



After the US regional bank crisis and the Credit Suisse bailout, the impact on banks' debt spreads is gradually fading as it has not become a systemic issue. Despite some risks remaining in the sector (inverted curve, falling deposits) we should have seen the worst of the crisis and central banks, as well as governments, have shown their ability to address the problem. Banking sector fundamentals remain sound (especially in Europe) and may benefit from yield curves steepening when this happens. Subordinated bonds' current yields are attractive (issuers have an investment grade rating at their senior debt level) and we expect some more performance catch-up in the coming months. We clearly prefer this segment to high yield as a high beta exposure.

Regarding Emerging Markets, fundamentals remain sound, and valuations are attractive, notably compared to the high yield sector in developed markets (higher spreads). Two key factors are now tailwinds for EMs, though a definitive confirmation is needed: the US dollar has initiated its downwards move, and US yields may have peaked. This is clearly positive for EM hard currency debt. Many EM countries have been ahead in their monetary tightening cycles compared to DMs, therefore peaking earlier. A possible rebound in commodity prices in the second half would also be positive for commodity exporters. We will move our exposure to neutral from slightly underweight: the risk here remains further rate tightening in the US and a rebound in the dollar.

FOREX

In 2022 the dollar index appreciated by 8.2% but began to fall in September as the Fed slowed its rate hikes while other central banks continued to raise rates aggressively.

In the first half of this year, the dollar index remained relatively stable, in line with our technical and fundamental scenario.

We believe that the dollar, as represented by the dollar index, is fundamentally expensive and should weaken in the long term. From a technical point of view, the dollar index recently opened the door to a target of around 94 (another 8% downside potential).

As for the EURUSD, we expect a short-term correction towards 1.08, followed by a rebound to a long-term target of around 1.20. For sterling, we believe that the risk/reward profile is not very favourable, even if our theoretical long-term target is around 1.40. For the Japanese yen, we believe it offers the best upside potential against the dollar, with a target of 110 for the USDJPY. Commodity-linked currencies could benefit from a rebound in commodities (which have partly priced a global recession).

The Swiss franc has strongly appreciated this year, reaching exaggerated overbought levels against most other G10 currencies. We expect the USDCHF to rebound to at least 0.95 in the medium-term, and above parity in the long term. On a Purchasing Power Parity basis, the Swiss franc is the only G10 currency to be overvalued against the dollar, with a fair value at 1.05 for the USDCHF.

The trade balance, foreign exchange reserves and sight deposits have all been declining since 2022. This is the result of a strong franc hurting exports and the SNB's decision to sell foreign currencies and contain inflation. We believe that the appreciation of the franc is excessive at these levels and that the SNB is ready to intervene soon and start selling the franc.

Finally, if we look at the USDCHF in relation to the interest rate differential between the US and Switzerland, we can see a positive correlation, but also, and above all, a strong and extreme divergence of late. We believe that the USDCHF has already anticipated a narrowing interest-rate differential. The SNB has historically proactively followed the Fed's monetary policy, perhaps more so than the ECB, and we believe that the rate differential will not be as pronounced as what the market expects.

Dollar Index – Monthly (last 5 years)

A final word on gold, which is heavily dependent on the evolution of the US dollar and US real interest rates.
US real interest rates suggest that gold should trade at much lower levels. In the short term, it could remain supported by the dollar weakness, but recent moves show

some divergence and highlight the downward pressure on gold.

We are underweight gold at current levels and are playing within the range of the last four years, between 1650 and 2050, with a neutral point around 1850.

HEDGE FUNDS

Our message has not changed: we are still positioned in "uncorrelated" hedge funds with the objective of generating alpha independently of the two major traditional asset classes.

The first half of 2023 was difficult for hedge funds, with an average performance of +0.6% to the end of June. Interestingly the sensitivity of strategies to equity indices has fallen sharply, underlining hedge funds' conservative stance towards the financial markets.

The Equity Hedge strategy was up 3.0%, with a sensitivity to global equities of 20% versus 45% historically.
The Macro/CTA strategy was flat and highly (negatively) dependent on bond markets.
The Relative Value Arbitrage strategy is up 2.2% thanks to bond volatility, which stabilised and even fell.

The Event Driven strategy was down 3.0%. This strategy suffered from weakening credit conditions, stricter US and European regulations, a sharp drop in corporate activity, deal break-ups, fund liquidations and widening deal spreads. The combination of these factors contributed to a drawdown of around 13% in the strategy.

We believe, from both a fundamental and statistical point of view, that the strategy should benefit from a better environment and rebound from current levels. We particularly favour the Merger Arbitrage and Credit Arbitrage sub-strategies, which can offer high single digit yields.

Hedge Fund strategy & sub-strategy map

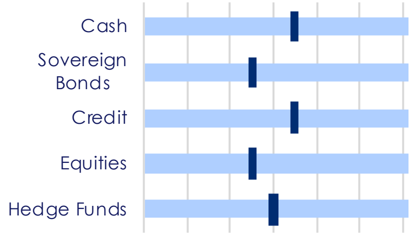
EQUITY HEDGE	EVENT-DRIVEN	MACRO-CTA	RELATIVE VALUE ARBITRAGE
Equity Market Neutral	Merger Arbitrage	Systematic Diversified CTA	Fixed Income Credit
Fundamental Growth	Special Situation	Discretionary Thematic	Fixed Income Corporate
Fundamental Value	Credit Arbitrage	Active Trading	Fixed Income Sovereign
Quantitative Directional	Activist	Currency	Fixed Income Convertible
Short Bias	Distressed Restructuring	Commodity	Volatility
Multi-Strategy	Multi-Strategy	Multi-Strategy	Multi-Strategy

POSITIVE NEUTRAL NEGATIVE

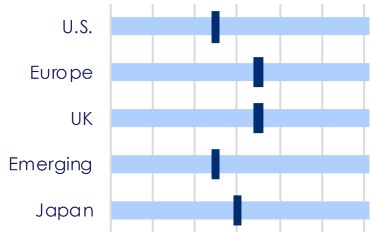
Nicolas Besson, Adel Chekir, Matthieu Dulguerov

Relative Positioning

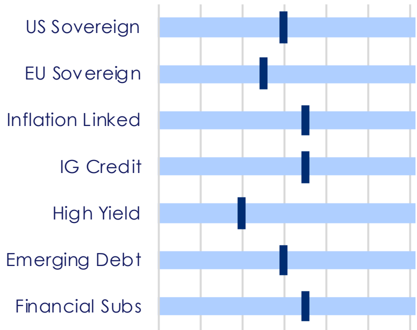
Asset Classes



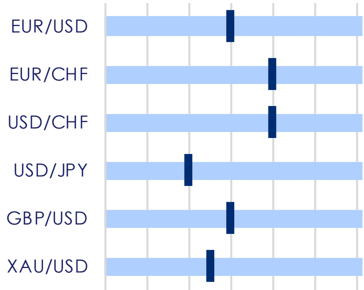
Equity Regions



Fixed Income



Currencies



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