Mt Fort Advisers
- Investment Strategy Update -

December 2022

Dear All,

We are delighted to present you our latest investment strategy update with the contribution of our independent macro strategist, Prof. Michel Girardin. You can access it by directly clicking here and send us a request to receive a password.

We are finishing the year 2022 only modestly better than when we wrote our investment update at the end of June. At that time, we were still digesting the invasion of Ukraine by the Russians, the sever lockdowns in China and higher inflation figures pushing central banks to tighten monetary policies aggressively. As a result, the S&P500 closed H1 2022 sharply negatively with a brutal -20%.
As we write, the S&P500 is still down a severe -19%. The Ukrainian war is still raging and there is no visible end to the conflict in sight. So far, the induced gas and broader energy crisis has been kept under reasonable control. Subject to a not too harsh winter, and thanks to the accumulated Russian gas reserves during the past summer, European countries should be able to navigate the cold period without major power disruptions. The pandemic seems to be fading across most regions, although China is going through a significant increase in infections due to the abandon of their "zero-Covid" policy. This should be ultimately beneficial to the reopening of the Chinese economy although it might take place gradually. Central banks have kept pressing the gas pedal though with tighter monetary conditions. The Fed resumed its interest rate hiking cycle. After 150bps in H1 2022, it hiked four times in H2 2022 for an aggregate 275bps to reach a fed fund rate at 4.5%. This is the second fastest rate hike cycle in the US with 425bps cumulative increases in less than ten months (the fastest one occurred in August 1980).
In this context, bond yields surged to new highs with the US 10-year yield reaching an annual peak at 4.3% sending bond portfolio returns to abyssal lows (-14.5%). A traditional US 60/40 investment portfolio, i.e. composed of 60% invested in US stocks and 40% in US bonds, returned a negative performance of -19% YTD. That ranks 2022 as one of the five worst years of performance since 1900 and, excluding 2008, all were over 80 years ago.

Where do we go next? Within our base scenario, we are assuming a status quo with the Ukrainian conflict, no significant adverse developments on the energy crisis and a fading pandemic across the world including in China over the course of the next few months. Our main focus is therefore placed on the future economic growth, inflation/labour market, earnings and valuation multiples. Generally, the economic activity is slowing down with most PMIs decreasing and pointing towards a most likely a recession. This is particularly acute in the EU which is more directly affected by the energy crisis. In the US, consumption remains resilient tough, and the labour market is particularly tight with an unemployment rate at its low at 3.7%. If a recession occurs, we reckon it might be a shallow one according to our base scenario. With 1.8 job openings for every unemployed person in the US, companies should be able to cope with the slowdown in business activity by cutting back on hiring, rather than making people redundant. A wage-price spiral should be avoided. We reckon that inflation has peaked. US mortgage rates reaching 7% have pushed real estate prices lower cooling down rents. Energy prices corrected from their elevated levels. The Fed has already started decelerating its hiking pace with its latest interest rate increase at 50bps instead of 75bps. Although at least two more rate hikes have been anticipated by the market, the Fed should reach its terminal rate in H1 2023 before pausing, according to our most likely scenario.

Periods of Fed pause have been favourable to financial markets historically with a positive performance of +10.6% on average and 78% of positive occurrences. Although not impossible, periods of two consecutive years of negative performance occurred only three times on a US 60/40 portfolio. In particular with yields much higher than last year and an interest rate hiking cycle closer to its terminal phase, bonds should achieve positive total returns in 2023. On the equity front, current markets are trading at 18x forward earnings, close to their long-term average at 17x, pricing already the expected slowdown considering the current much higher yields. We are cognisant that a more severe recession would push earning growth in negative territories with markets most likely adjusting PE multiples to lower levels despite a potential more dovish Fed at the time. This is one of our key risks in our base scenario for H1 2023. We would remain nimble and use dynamic hedging strategies via bear put spreads to protect our long equity position tactically.

The environment will remain choppy and challenging. In that context, we can only reiterate the importance for investors to validate periodically that their key investment objectives are in line with their portfolios, in particular in terms of risk appetite and liquidity requirements.

We are exposing in more details Prof. Girardin's macro views and thoughts on the financial markets, while we also discuss our core themes and positioning for the first half of 2023. You can access the full investment strategy update by clicking here and send us a request to receive a password.

We would be delighted to discuss it in more detail and exchange on your valuable thoughts.

In the meantime, the whole Mt Fort Advisers Team wishes you and your loved ones a merry Christmas and an exciting New Year 2023!

We thank you for your continued trust and support,

Your Research Team

MT FORT ADVISERS SA
Rue de Lausanne 20bis
CH - 1201 Geneva

+41 22 568 10 01

www.mtfortadvisers.com

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