Mt Fort Advisers
- Investment Strategy Update -

July 2023

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 use **MtFort2023** as the password (we are not attaching the pdf herewith to avoid anti-virus/spam filters).

What a **stark contrast** to last year performance, which pointed to an abyssal return of -19% based on the general proxy of a traditional 40/60 US portfolio. Markets pivoted remarkably during the first half of this year with the MSCI World index showing a positive return of +14%. The pandemic, the Ukrainian conflict and the energy crisis seem all long gone from the current financial market perspective, quickly replaced by the surge in artificial intelligence presented as a technological revolution. The **performance** picture has been **very contrasted** though with most of the gains concentrated among a limited number of mega cap growth stocks. As a matter of fact, the top 7 largest stocks of the S&P500 index, "**the magnificent 7**", represented 85% of the gains of the total index. Excluding those top 7 stocks, the S&P500 is showing a mere positive return of +3.9% in H1 2023.

As expected, **central banks** have dominated the stage keeping the pressure up with tighter monetary policies to combat inflation. The Fed **increased interest rates** by another 75bps since the beginning of the year, although it reduced its pace compared to last year during which it hiked rates by a total of 425bps. With a cumulated rate increase of 500bps, the Fed successfully contributed to **cool inflation**, which peaked at 9.1% in July, to 4.1% currently. While one of the main Fed's missions, price stability, is being addressed, it does challenge one of its other missions: moderate long-term interest rates and ensure the **stability of the financial system**. The swift and brutal increase in interest rate has caught small and mid-size regional banks off guard due to large exposure to unhedged long duration bond portfolios against highly concentrated client portfolios of uninsured deposits. Several banks faced a bank run exacerbated by the swift spread of information thanks to social media, forcing the Fed and the US government to step in to safeguard the stability of the US

banking system. It did not prevent though the **collapse** of some prominent **banking names** such as First Republic, SVB, and Signature Bank, currently the second, third, and fourth largest bank failures in US history, respectively, after Washington Mutual, which went bust during the 2008 GFC. Indirectly and for different reasons, the damage extended to one of our Swiss national banking champions, Credit Suisse, resulting in its bail out by UBS with the support of the Swiss government. A rather shameful event jeopardizing 167 years of banking history because of a reckless and greedy management driven by a culture of short-termism and profits at any cost/risk.
While this **banking crisis** seems controlled at present, the stability of the banking system is far from achieved and will remain a concern over the coming months due to higher interest rates. The Congress is currently debating on more stringent regulation on the smaller banks and the necessity for additional guarantees on deposits for a specific period. Additionally, there are concerns related to **commercial real estate loans** with the CRE sector suffering from the pandemic shock and structural changes, such as WFH and greater work flexibility, decarbonization and the need to revamp buildings, combined to higher financing costs and tightening credit standards. **Banking exposure to CRE loans** amount to over $2.4tr. This is significant compared to the total aggregate equity capital of US banks amounting to circa $2.2tr. To note, 80% of CRE loans are granted by banks with less than $250bn in assets.
Despite those concerns, the **financial markets** seemed globally **undeterred** by this banking crisis. They did correct about 7% prior to the collapse of SVB and Signature Bank at the beginning of March, which marked a bottom in the first half, before bouncing back right after with a 16% rally to their high on June 20th.

Although **inflation receded** from its highs, there is still a long way to reach the 2% Fed target, which remains its confirmed goal for now. The **US Central bank holds most of the cards again** on the future trajectory of the economy and to a certain extend the financial markets. The Fed is still anticipating one or two more **rate hikes** in 2023 before cutting interest rates in 2024, according to the latest FOMC dot plot. This is currently **not fully priced** in the financial markets, which are expecting the Fed to pause at the current level or after one more hike followed by a first cut by the end of 2023 or the beginning of 2024 according to the Fed fund futures. This is our **main ground for caution** during the second half of 2023 despite a benign macro environment at this stage.

Our macro strategist, Prof. Michel Girardin, reckons that **recession risks are still low** at present in the US, thanks to a very resilient labour market. There are currently a record 1.9 job openings for every unemployed person. This means that companies will be able to cope with the slowdown in business activity by cutting back on hiring, rather than making people redundant. According to Prof. Girardin's new indicator, which is inspired by research published by the St. Louis Fed, the unemployment rate should exceed its 18-month low by more than 0.5% to mark the beginning of a recession. It is currently below 0.3%. Additionally, consumer confidence in the US remains strong and points to a recovery. In Europe, **economic indicators** have also **bottomed out** of recession territory. In Germany, recession came and went. Our indicators point to a solid rebound.
China should also contribute to the world economic growth. We do not anticipate China to be as deflationary as some other economists expect. Domestic consumption is rebounding post three years of stringent lockdowns and the lack of inflationary pressures give the PBoC lots of scope to ease monetary policy and further stimulate the economy if required.

Global **equities** tend to **outperform** global **bonds** during economic recoveries and conversely. The performance gap between the MSCI world for Global equities and the Citigroup Government Bond Index for Global bonds is currently reading +12.3% (i.e. Equities outperforming Bonds by 12.3%), which is far away from its greed territory (+30%). **Equities** are currently **fairly valued** with the MSCI World index priced below 16x and its long-term average. **China** is looking particularly **inexpensive** with a PER below 10x and trading at almost a 40% discount to World Equities. **US equities** are showing slightly **richer valuations** with a forward 12 months PE at about 19.6x compared to its fair value at 17x. **Growth stocks** are set for a **continued rebound**. After an extensive 80% premium against value stock and the subsequent correction in 2022, growth stocks are now trading at a modest 20% valuation premium in terms of PER. The forthcoming end of the monetary tightening should act as a catalyst for growth stocks, despite some higher volatility shorter-term.

With interest rates close to their peak, we see **value in government bonds,** especially in the US, but also in emerging markets. The aggressive tightening of the Fed should reduce inflation expectations and stabilize the long end of the curve.

On the currency front, the **USD** will **lose** from **FED support** and should keep its weakening trajectory against the main currencies.

There is still generally a great deal of **confusion and noise** in the financial markets. Within a few months, investors gyrated from a hard landing and a recession, to a soft landing, and then to no landing with an acceleration. Same on the interest rate front, where investors expected a rate cut in July and now a rate hike. The most evident conflicting message comes with the **inversion of the yield curve**, which points to recession, whilst steady returns on the stock markets point to a soft landing of the economy. We do **not** think that the yield curve inversion is a reliable indicator of a forthcoming **recession** due to the distortion created by QE policies. A research conducted by the Fed estimates that 10Y bond yields are approximately 150 basis points where they would be, had the Fed not carried out its QE.

Once again, all eyes will be on the Fed and other central banks on their next monetary policy actions. The current surge in bond issuances from the US treasury department post the debt ceiling resolution is draining liquidities out of the market. The next FOMC meeting could validate another hike of 25bps adding pressure on the banking system and further tightening financing standards. The **risk of an overkill** from central banks is a real threat to our overall globally constructive base scenario. In that context, we would keep a **neutral stance** and use **tactical hedges** to protect accumulated profits during the first half of the year. The current low breath of equity market performance, low volatility, a recent shift in market sentiment turning bullish, and ongoing geopolitical uncertainties in Ukraine/Russia, Iran and Taiwan, are all factors adding to our **cautious stance** despite keeping a long neutral exposure globally.

We would expect **volatility to increase** during the second half and as always, we can only reiterate the importance for investors to validate periodically their key investment objectives and ensure their portfolios are in adequation particularly 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 second half of 2023. You can access the full investment strategy update by clicking here.

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 warm summer in the Norther hemisphere and a snowy winter in the Southern hemisphere.

We thank you for your continued trust and support,

Your Research Team

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