



Investment Strategy

April 2023



"THERE IS A BEAUTY THAT REMAINS
WITH US AFTER WE'VE STOPPED
LOOKING."

CORY RICHARDS,
PHOTOGRAPHER AND EXPLORER, WEARS THE
VACHERON CONSTANTIN OVERSEAS.


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CONTACT US +41 22 580 1755

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INTRODUCTION

Letter to Investors - Investment Climate

- Waltzing economic scenarios punctuated by waves of uncertainty
- Banking crisis and threats to the stability of the financial system
- New paradigm for the evolution of monetary policies
- A generally positive first quarter for stocks and bonds
- Phasing out of the main risk factors by 2022
- Relatively favorable conditions for financial assets

The first quarter of 2023 started off very well. The month of January and the first weeks of February benefited from a rather positive scenario in which the evolution of inflation played a central role. December saw the first inflation figure close to zero (+0.1%) in the United States, which suggested that the downward trend in the monthly figures in a new acceptable inflation regime had indeed taken hold. After six months, it seemed likely that this trend would continue into early 2023. The Federal Reserve also suggested that the pace of rate hikes could be reduced to 0.25% with a maximum target rate of about 5.0% by June. The economic scenario in place at the time assumed a gradual slowdown in economic dynamics with restrictive effects on inflation, allowing to envisage an early end to the rise in key rates. An exceptional January crowned these expectations before they were completely reversed in mid-February. The release of a rebound in US inflation in January to +0.5%, followed by an extraordinary job creation figure of 517k, well above expectations of 189k, have together set the world on fire. The central bank was quick to confirm that if the economy continues to be very strong, it will not hesitate to raise interest rates longer and higher. A sudden change in scenario appeared, described as a *no-landing scenario*, with extreme implications for interest rates and financial assets.

A 100 bp adjustment in Fed funds rates for December 2022 was accompanied by a similar move in short-term yields. All yield curves then adjusted upwards, without considering that this scenario was unlikely to materialize. The U.S. economy was indeed much less resilient than the lagging data on the labor market or rents suggested. While the economic slowdown seemed increasingly clear in many other economic statistics, general sentiment remained affected by negative expectations of a permanently restrictive policy for the coming months, and this led to a direct drop in the performance of financial assets.

The banking crisis at the beginning of March then brutally reinforced the prevailing uncertainty and provoked a wave of panic for a few days, raising fears that a new systemic situation similar to that of 2008 could seriously threaten the perennality of the international financial system. It only took a few days of panic to bring down Credit Suisse and to push central banks and governments to adopt a resolute attitude by which they reaffirmed the solidity of the banking system while completely reversing the policies displayed until then. The banking system, while completely reversing the policies they had been pursuing up to that point. The central banks have indeed reassured investors and savers by providing all the liquidity necessary to avoid any systemic risk of contagion from the SVB bankruptcy, causing the Fed's balance sheet to jump by 500 billion, or about 6% in a few days. The rescue of Credit Suisse had a greater impact on the balance sheet of the SNB, estimated at more than 20%. This reversal of trend constitutes a whole new paradigm for central banks, which are revising

their language by claiming to be able to decouple their policies to fight inflation by maintaining high key rates from those aimed at ensuring the stability of the financial system by injecting massive amounts of liquidity and offering guarantees of various kinds.

This latest episode of inflating systemic risks is still far from having developed all its effects in the medium term, but in the short term the result is clear: policy rate expectations have massively readjusted. Fed funds rates for December have fallen by 150 bps, and June Fed funds are now below the current key rate of 5%, implying an expectation that the Fed will cut rates in the coming months. The yield curves have also corrected, with more dramatic declines at the short end. The two-year US Treasury yield fell from 5.08% to 3.55% in just over two weeks.

The impact on bond prices was immediate, and March performances were therefore positive in all markets, supporting the gains recorded everywhere over the first three months of the year. Overall, bond indices returned around +3% for the quarter, with Australian bonds performing best among developed markets. Equity markets also rebounded at the end of the month with lower yields and assurances from central banks. Up +3.09% for the month of March, the *MSCI World index* ended the quarter with a satisfactory +7.7% gain and a record rebound for European stocks of +14.3%. The securitized real estate investments are still lagging the end-of-quarter recovery (+0.5%), but conditions are also favorable for them to catch up.

The stock market climate at the beginning of the second quarter is still very much affected by risks of a financial crisis, but the conviction has taken hold that the rate hike cycle is probably over in the United States. If the next statistics confirm both the weakness of the economic dynamic and a better inflation trend, the decline in yields could well continue and support a new bullish rally for all asset classes. As for commodities, the outlook should be strongly linked to the recovery of activity in China and India. While energy and industrial metal prices are likely to benefit, precious metals will rise with the support of lower rates and a weaker dollar.



Alain Freymond
Associé & CEO
BBGI Group

BIG PICTURE

Main Convictions

- The global soft landing scenario once again seems the most likely
- Inflation remains a key factor in risk assessment
- Monetary policies again less restrictive
- Favorable outlook for financial assets

The global soft landing scenario once again seems the most likely

The current quarter should already be the one to dismiss fears of a *non-landing* of the U.S. economy and to re-validate the main and most likely scenario of a gradual slowdown of the global economy. After a few weeks of fear in February and March that the US economy would not react to interest rate hikes and would instead continue to grow at a solid pace, these fears have now faded, probably due in part to the as yet unseen indirect effects of the March banking crisis. Investors have finally taken into account the deterioration in economic conditions in the United States on many fronts, while also taking into account the potentially harmful effects of this crisis on the banks' lending conditions. The difficulties in the banking sector will indeed affect the process of granting credit to individuals and businesses, while banks will undoubtedly seek to improve their solvency ratios.

In the United States, leading and coincidental indicators continue to deteriorate and indeed point to a likely weakening in economic activity. However, while the manufacturing sector is showing signs of weakening and household consumption is slipping dangerously close to a recession, the service sector is still showing some resilience. In Europe, the economic surprises were rather positive during the last quarter and the beginning of the year did not cause any significant reversal of the situation. The growth outlook for the year as a whole therefore seems slightly less pessimistic and expectations for the first quarter of 2023 suggest a limited contraction of -0.1% followed by a second quarter also in decline of -0.2%. In the UK, the economic environment also appears surprisingly resilient despite the tightening of monetary conditions and the decline in household disposable income. We believe, however, that a recession is still likely, but that it could ultimately have relatively limited effects. In Asia, the Japanese economy avoided a technical recession by recording an annualized increase of +0.1% of its GDP in the fourth quarter of 2022, confirming the expected weakness of the economy. The outlook for the first quarter of 2023 is only slightly better, with GDP still suffering from insufficient household consumption. The return of Chinese growth following the end of the zero-covid policy will gradually develop positive effects, partly offsetting weakness in the Western countries.

Inflation remains a key factor in risk assessment

For several years now, the evolution of inflation has been one of the main risk factors to be taken into account when monetary policies that will be adopted by central banks and whose effects on interest rates and access to financing will have a decisive impact on the valuation of financial assets and the investment climate. We had already alerted investors in 2020 to the risks of inflationary slippage directly linked to the very expansive monetary and fiscal policies that were being pursued in most Western countries to contain the negative effects of health policies to fight the pandemic. While central banks still considered the emergence and development of inflation as a transitory factor, we noted that the expansion of liquidity and historically low interest rates in some countries would eventually develop more lasting effects on inflation measures. The rhetoric of the central banks only adjusted to

this reality belatedly, recognizing the sustainability of inflation when the war in Ukraine reinforced the trends already in place. They seem to be exercising the same excessive caution today by not taking sufficiently into account the forces that are already influencing the evolution of prices and being slow to recognize the progress that has been made. In reiterating their 2% inflation target, they tend to downplay positive developments by pointing out too dogmatically that these are still insufficient compared to their expectations.

The deceleration in prices is nevertheless evident in a number of countries, starting with the United States, even if this trend is still far from the Fed's objective. Through its actions and statements, the U.S. Federal Reserve has sustained a sense of permanent disappointment among investors by stating that it will maintain an anti-inflationary policy as long as its objective is not met. Yet the monthly inflation regime has changed dramatically from the first six months of 2022 to the current period. A particularly notable improvement which deserves to be discussed with a little more objectivity and less dogmatism. While inflation was rising at a monthly rate of +0.8% in the first half of 2022, it has only been advancing by an average of 0.28% per month for the past eight months in the US. In a 12-month projection, US inflation is now close to 3.4%, which is already close to 3.4%, which marks a clear decrease since the peak of +9%/year reached in June 2022, which the central bank could already be satisfied with. We believe that US inflation is on an encouraging downward trend, which will certainly be reinforced in the coming months by the ongoing economic slowdown. The inflation situation remains different in the UK and Europe. In both cases, it is not expected to make as rapid progress as in the US. But over a 12-month horizon, we should still see a reduction in pressure, allowing annual inflation to settle below +4% in the US, China and Japan. The euro zone will remain a little behind with a consumer price index probably still above +5%.

The expected gradual decline in inflation to an « acceptable » level in the major economies is a key factor in assessing the risks ahead. The announced downward trend seems to us to be sufficient to favorably influence monetary policies. Moreover, the recent banking crisis will also be taken into consideration by central banks, which will undoubtedly consider that it should develop effects on the evolution of demand and prices, justifying less restrictive policies. This context will allow a downward readjustment of yields on the dollar capital markets in particular. Such an improvement will lead to a readjustment of the risk parameters for the financial markets in the coming quarters.

Monetary policies again less restrictive

After a month of February already marked by the appearance of a highly unlikely *no landing scenario*, the risks of recession reappeared again in March. The bankruptcy of the SVB and the shock of the disappearance of Credit Suisse in a week of very high risks for the global banking sector and the financial system had repercussions on most financial markets, causing a wave of panic for a few days, raising fears that a new systemic situation similar to that of 2008 could seriously threaten the sustainability of the international financial system. The reaction of the main monetary authorities was swift and serious, as they largely reaffirmed the soundness of the banking system while completely reversing the QT policies displayed until then. First of all, they reassured investors and savers by providing all the liquidity necessary to avert any systemic risk on a massive scale, abandoning their QT and temporarily returning to a form of QE.

This reversal of trend constitutes a whole new paradigm for central banks, which are revising their language by asserting that they are able to decouple their anti-inflation policies on the one hand, by maintaining high key rates, and on the other hand those aimed at ensuring the stability of the financial system by injecting massive amounts of liquidity and by offering guarantees of various kinds. Expectations of future policy rates changed immediately, with bond yields falling by around 100 bps. Fed Funds are now already below the Federal Reserve's current policy rate for the June maturity. This is now a new paradigm for monetary policy, which is perceived to have already reached its zenith and is close to an easing phase in the US.

The second quarter will be clearly characterized by the end of the convergence of monetary policies between all central banks. Some of them will mark the end of the monetary tightening cycle during this period by pausing in their rate hike process. This will be the case for the Fed in particular, which should now refrain from raising its key rates before proceeding with further easing, perhaps at the end of the year, if the economic slowdown proves to be more severe and deeper than expected. For the ECB and the BoE, the path is more uncertain; they will have to make a few more hikes before reaching their inflection point, while in Japan, monetary policy will remain accommodating.

Relaxation and stabilization on the yield curves

The banking crisis and questions about the stability of the financial system in March led to a complete reversal of forecasts on the future course of monetary policy and a sharp readjustment of expectations on the bond markets, while the *soft landing* or even recession scenario became more consensual, as we had expected. The drop in short-term yields was rapid and completely correlated with the adjustment in Fed Fund Futures expectations, but it was also significant at the longer end of the yield curve. Bond yields have eased across the board and have since stabilized well below their October 2022 highs. We believe that in this weaker economic environment, the risks of a further pickup in inflation are much lower than the chances of a sharper slowdown and decline in price developments in the US in the coming months. Yield curves have flattened as yields have fallen more sharply at shorter maturities. The yield spread between 2 and 10 year US Treasuries has fallen from 110 bps to 60 bps, returning to the level of summer 2022.

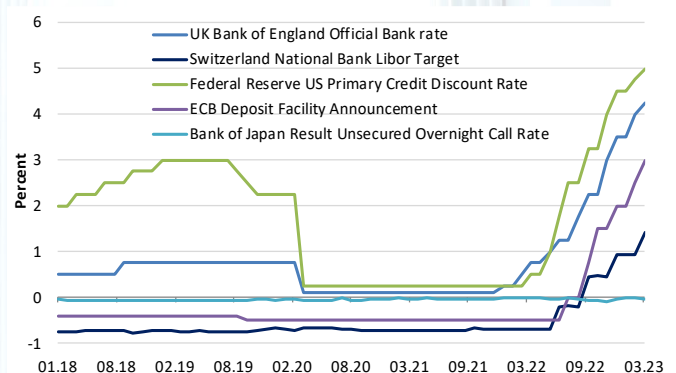
In this context, the correlation observed in 2022 in the bond markets will not continue in 2023, as monetary policies and inflation outlooks are sufficiently different to cause opposing movements in Europe, the United Kingdom and Japan in particular.

Favorable outlook for financial assets

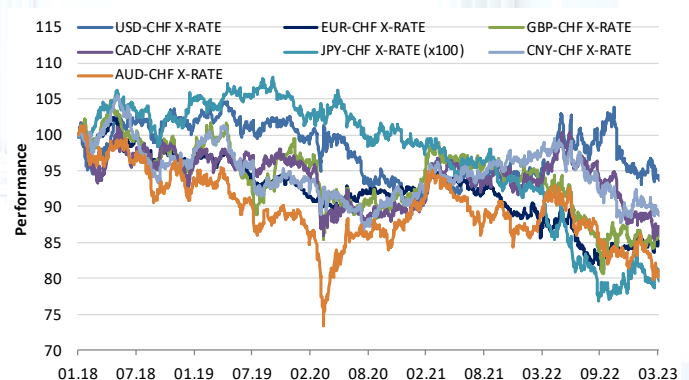
Inflation will remain the main factor to watch in the coming months, but an easing in prices remains the most likely scenario given the more difficult situation for consumption and economic growth. The ongoing slowdown should provide support for expectations of a softening of some yield curves, while the return of QE and an increase in global liquidity could also contribute to this trend.

Financial assets should benefit from this change in sentiment and paradigm shift resulting from the complete change in the macroeconomic scenario and interest rate expectations. After a particularly uncertain and volatile first quarter, the stock market climate has unfortunately not yet returned to serenity at the beginning of spring. However, a reduction in inflationary pressures and rate uncertainties will have a positive impact on the capital markets and on securitized real estate. For equities, the first quarter earnings season should not already be affected by the prospect of an economic slowdown, as earnings growth expectations are already rather low for the year as a whole.

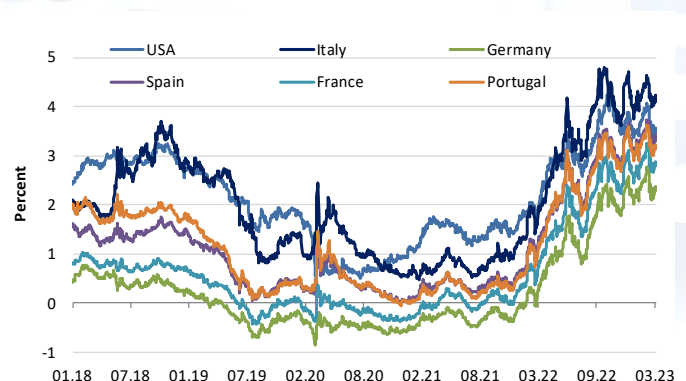
Policy Rates (EUR, CHF, GBP, USD, JPY)



7 Main Currencies against CHF (base 100)



10-year Government Rates





Information

You can obtain information at any time by contacting BBGI Group SA:

T : + 41 22 595 96 11

F : + 41 22 595 96 12

E : reception@bbgi.ch

Or by sending your requests for information by post to the following address:

BBGI Group SA
Place de Longemalle 1
1204 Geneva

www.bbgi.ch

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