Equity Market

Q&A (based on popular customer questions)

1. **How realistic is it to capture short-term market bounces and are there alternatives to strategic portfolio management?**

Much depends on your ultimate goal and risk tolerance, as the time frame in which the opportunity arises is essentially quite short. The main issue is not just to track short-term changes, but also to time your entry and exit, rather than a strategy to follow the changing stages of the economic cycle. It should therefore be understood that this approach is riskier and therefore more volatile, which may not be suitable for investors with a low or medium risk tolerance.

2. How many more years of equity market turbulence can we expect?

At the end of the first quarter of 2023, we estimate this period to be between 1 and 2 years. This variation depends on those first indicators of a recession or a second wave of inflation that are now important not only for the market but also for central banks. These factors include:

- Rising US unemployment (in particular, it is customary to consider the official start of a recession when the unemployment rate rises by 0.5%)
- Bankruptcies in interest-sensitive sectors - banks, housing. Defaults in these sectors could lead to a reassessment of the sustainability of the interest rate over a given time horizon.
- A return to rising inflation as a result of possible mistakes by the Federal Reserve (for example, in the 1970s, when Paul Walker was head of the Federal Reserve, a series of interest rate decisions led to a new wave of inflation and the subsequent devastating processes in the economy that triggered the stock market crash).

3. Speaking of recessions and asset prices, is it safe to say that "everything is already priced in"?

Before the news of the SVB bank collapse, the S&P500 index was pricing in a 28% chance of a recession within 12 months. That was in March 2022, when interest rates were close to zero. That probability is now around 45%, but still lower than in the second half of 2022. European equities put the probability at 44% and Chinese equity indices at 55%. Aggregate estimates across markets suggest a lower-than-average growth scenario for now, but not yet a recession. The only asset classes that are pricing in growth globally are oil and China's medium-term interest rates.

Debt capital markets

Q&A (based on popular customer questions)

1. **In a high interest rate environment, why not buy Treasury bills yielding more than 5% and move into riskier instruments?**

Short-term and ultra-short term instruments are primarily designed to solve liquidity problems, but their returns are highly dependent on the US Federal Funds rate and there is no universal solution in the long term. This means that investors face reinvestment risks when the instrument matures. This is one of the reasons why we recommended a high money market allocation in 2022 against a backdrop of systematic interest rate hikes.
An example of this reinvestment risk would be if interest rates were 2% in December 2019 and 0% in March 2020.
Another important reason is the approaching maturity date, which means that for “riskier” types of debt, it is possible to fix the duration of the bonds, which in fact corresponds to a low level of market risk.

2. **What is the role of TIPS (Treasury Inflation Protected Securities) in a falling inflation environment and should they continue to be held in a portfolio?**

In 2022, TIPS showed negative momentum and coupon payments were even lower than short-term debt. To some extent, this was due to a surge in inflation and the failure of interest rates to keep pace. By their very nature, TIPS are "real yield" instruments, where the yield is calculated using a conservative inflation rate. As interest rates rise and inflation falls, an inverse trend is created that lasts at least until interest rates fall, giving the investor the opportunity to participate in price appreciation by receiving coupons as the "real yield" rises.

3. **For how long should we avoid HY (high yield) bonds, i.e. corporate bonds from financially strong companies that pay a significant coupon?**

In recent quarters, HY bonds have shown a high correlation with the equity market. Against the backdrop of the recent banking crisis and the tightening of bank credit, companies with less robust financials will find it harder to secure debt against a negative macroeconomic backdrop. The average current yield on HY does not fully reward the investor for the full range of risks that could materialise in the coming quarters. Cyclically, an increase in corporate defaults is likely, which could lead to a negative valuation of the HY sector as a whole.
In such a context, a more balanced decision would be to focus on investment-grade IG corporate bonds and, if desired, sell the riskier part at the expense of the equity portfolio.