NOVUM
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Quarterly Strategy Update

Navigating Uncertain Global Markets: A Look at the Key Factors

October 5, 2023

Highlights

- Europe is in a more challenging position compared to the US, largely due to an unfavorable mix of slower growth and persistent inflation.

- The recent surge in energy prices is expected to have a negative impact on both the US and Europe, although the US enjoys a strategic advantage with its energy independence.

- At the start of this year, following a period of weakness that coincided with a stock market rally and US dollar decline, the US dollar began to strengthen again in July. This strengthening, coupled with a rise in interest rates, is leading to tighter financial conditions.

- The labor market will also be a critical variable to watch. Signs of a slowdown in recent weeks may translate into a short-term decrease in employment, potentially providing the Fed with room to ease its grip on rates.

- Financial markets are likely to face a few difficult months ahead, with at best some consolidation in prices.

- In our strategic asset allocation, we maintain a defensive stance, with an underweight on European equities, a neutral stance on US equities, and an overweight on the dollar.

Since the beginning of August, global equity markets have been declining with the MSCI World index down -7.3%, raising concerns among investors and analysts. The market correction has come against a complex macroeconomic backdrop, which is characterized by persistently high inflation in both the US and Europe.

"Financial markets are likely to face a few difficult months ahead, with at best some consolidation in prices."

Figure 1: Year-to-Date, Past Three Months, & Peak-to-Date Returns

Equity Indices	Last Value	Last Quarter	Peak-today	Ytd
MSCI World	2,844.83	-4.11%	-12.42%	11.16%
Nasdaq	13,108.79	-4.93%	-16.09%	26.04%
S&P 500	4,278.74	-3.86%	-10.74%	12.79%
S&P Equal Weighted	5,730.30	-5.78%	-14.02%	1.30%
Russell 2'000	1,781.93	-5.65%	-21.46%	2.27%
Nikkei	32,371.90	-2.46%	10.48%	25.58%
Eurostoxx 50	4,136.23	-5.98%	-5.30%	12.37%
Swiss SMI	10,897.10	-3.40%	-15.53%	4.75%
FTSE 100	7,606.15	0.99%	1.34%	5.12%
Shenzen	3,700.50	-3.69%	-24.75%	-2.21%
Hong Kong	17,611.87	-6.90%	-24.38%	-7.86%
MSCI EM	947.18	-4.27%	-23.30%	1.46%

Equity Sectors	Last Value	Last Quarter	Peak-today	Ytd
S&P value	153.69	-4.14%	0.11%	7.41%
S&P Growth	68.15	-2.99%	-17.00%	17.49%
S&P Defensives	1,476.73	-5.60%	-15.90%	-4.60%
ARK Fund	38.86	-11.97%	-58.08%	24.38%
Magnificent 7	7,268.18	-1.34%	-0.30%	83.90%
S&P Banks	77.59	-3.27%	-44.69%	-20.87%
Euro Stoxx Banks	91.52	2.29%	5.00%	20.79%
S&P Energy	91.52	13.58%	65.52%	7.43%
Gold Miners	27.34	-9.22%	-11.42%	-4.62%

Commodities	Last Value	Last Quarter	Ytd
BBG Commodities	105.96	4.42%	-6.06%
BBG Agriculture	65.35	-1.69%	-5.05%
BBG Energy	38.44	19.39%	-6.78%
BBG Precious Metals	209.33	-3.04%	-2.60%
BBG Industrial Metals	139.49	-1.31%	-15.63%
BBG Brent Crude TR	1,234.18	27.05%	16.22%

FX	Last Value	Last Quarter	Ytd
DXY Index	1,270.29	3.02%	1.90%
GBP Index	637.18	-2.59%	2.30%
EM FX Index	1,668.07	-0.49%	0.45%
Bitcoin	26,232.29	-13.69%	59.30%

Bond Indices	Last Value	Last Quarter	Ytd
US Inv Grade	102.64	-4.11%	-0.02%
US High Yield	73.74	-0.31%	4.16%
Euro Corps	233.49	0.37%	2.56%
JPM Europe Govies	9,819.76	-1.54%	6.39%
US Treasuries	2,154.92	-3.07%	-1.53%
China Aggregate	251.04	0.05%	-1.66%
EMBI Global	780.28	-2.17%	1.56%
EMBI Local	128.18	-3.73%	3.63%

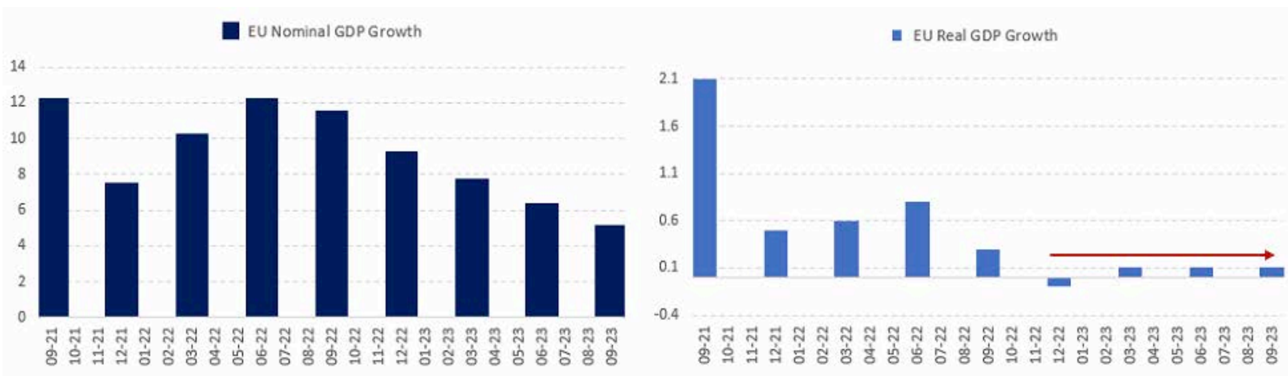
Source: Bloomberg, as at September 29, 2023. Performance figures in indices' local currencies. *Peak date for equity markets on January 4, 2022.

The striking difference between the two economic giants lies in their real growth rates. For instance, since the full economic reopening in mid-2021, the US has enjoyed an average real growth rate of 3.7%, with a robust 9.4% nominal growth. In contrast, Europe's real growth has lagged the US by a full percentage point, while experiencing similar levels of price increases.

As Figures 2 and 3 show, the two blocks are also heading in opposite directions. US growth has been accelerating in the past three quarters, with consumption supported by a solid labor market and investments from government programs, while Europe has stalled around zero. **Europe also finds itself in a more challenging position compared to the US, largely due to an unfavorable mix of slower growth and persistent inflation.** This is one of the primary reasons why we have a structural underweight in European equities relative to their US counterparts.

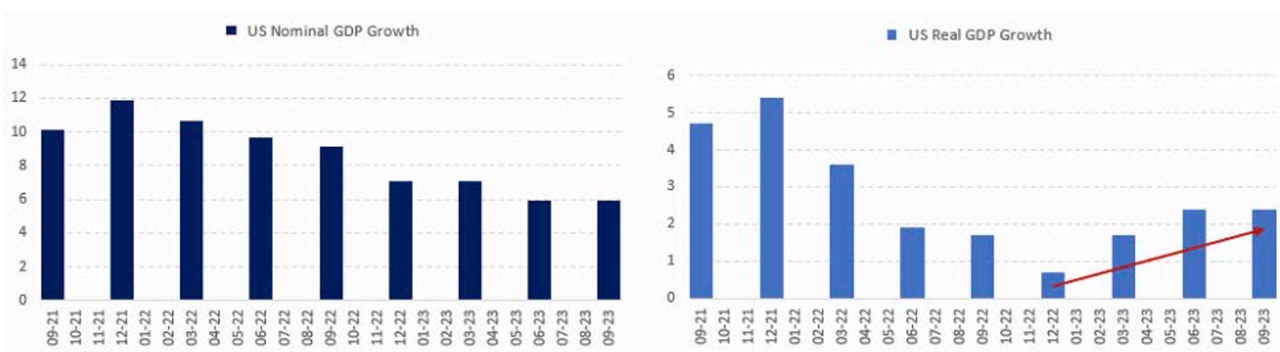
"Europe's real growth has lagged the US by a full percentage point, while experiencing similar levels of price increases."

Figure 2: EU Nominal (left) & Real Growth



Source: Bloomberg, as at September 29, 2023.

Figure 3: US Nominal (left) & Real Growth



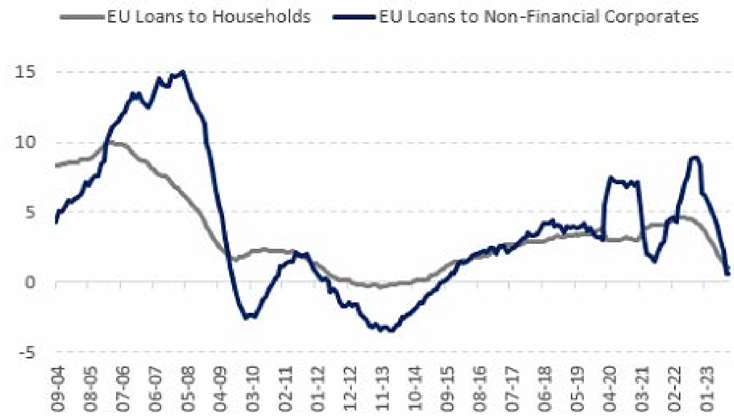
Source: Bloomberg, as at September 29, 2023.

"Services PMIs are joining the manufacturing sector in contraction territory, credit and monetary growth have started to contract, and the consumer is struggling..."

The European Central Bank (ECB) is also facing a conundrum. Growth indicators are showing weakness—the services PMIs are joining the manufacturing sector in contraction territory (below the 50 level), credit and monetary growth have started to contract, and the consumer is struggling despite a still favorable labor market. However, core inflation remains well above the ECB's 2% target, currently sitting at 4.5% year-on-year.

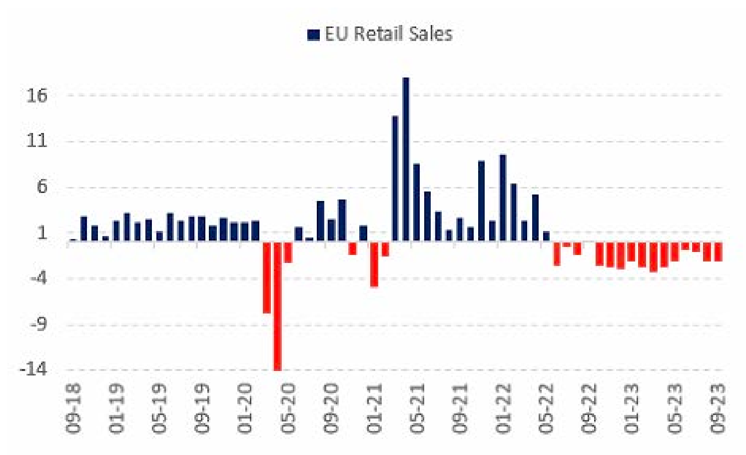
"In addition, two key countries in Europe are particularly challenged with their own problems at the moment."

Figure 4: EU Loans to Households and to Non-financial Corporates



Source: Bloomberg, as at September 29, 2023.

Figure 5: European Consumers are Struggling for More Than a Year Due to the Decline in Real Incomes; Retail Sales Contracted for 13 of the Past 14 Months in Real Terms



Source: Bloomberg, as at September 29, 2023.

"Given that Italy's public debt is almost EUR3 trillion, the impact of a permanent increase in rates on the annual interest paid by the state is devastating."

In addition, two key countries in Europe are particularly challenged with their own problems at the moment. Germany has to revise its economic development model, which was based on cheap energy (from Russia) transformed into exports (with an important outlet in China).

Figure 6: German Industrial Production Shows Contraction

Source: Bloomberg, as at September 29, 2023.

Italy, on the other hand, is again struggling with debt problems. We do not see a sustainability problem, but with the debt/GDP ratio above 140%, rising rates prevent any flexibility of expansionary policies in times of crisis, so economic growth will inevitably be limited. **Given that Italy's public debt is almost EUR3 trillion, the impact of a permanent increase in rates on the annual interest paid by the state is devastating—around EUR30 billion per year.** This suggests that in the coming years the private sector will have to manage on its own, without much support from fiscal spending.

Another problem that impacts Italy, but also the whole of Europe, is the wave of migration in the country. Unfortunately, Europe is struggling to find a common political line to deal with a problem that is difficult to resolve in itself, let alone by an isolated country. France and Germany appear to be somewhat short-sighted during this phase, showing very little solidarity with Italy, which is solely responsible for its geographical position facing the African coasts. The level of tension is so high in the country that we cannot ignore this factor for social stability, and the likely consequent negative impact on economic growth.

"The level of tension is so high in the country that we cannot ignore this factor for social stability..."

Elsewhere, the recent surge in energy prices is expected to have a negative impact on both the US and Europe, although the US enjoys a strategic advantage with its energy independence. With this macro framework, it is difficult to support the case for European equities, with cheap valuations being the only (but still relevant) supportive factor. As Figure 7 shows, forward multiples on the Eurostoxx 50 bottomed at 10 in 2022, rallied to 13 during this year, and are now declining again below 12.

On the earnings side, estimates for 2023 and 2024 saw a huge rebound with the post-Covid reopening. This rebound also allowed multiples to fall to very attractive levels, as earnings growth throughout 2022 was accompanied by a stock market decline. But at this point, economic weakness could easily threaten earnings in the coming quarters.

"This rebound also allowed multiples to fall to very attractive levels, as earnings growth throughout 2022 was accompanied by a stock market decline."

Figure 7: Forward P/E for the Eurostoxx 50 (yellow line), 12-months and 24-months Forward Earnings (white and green line)

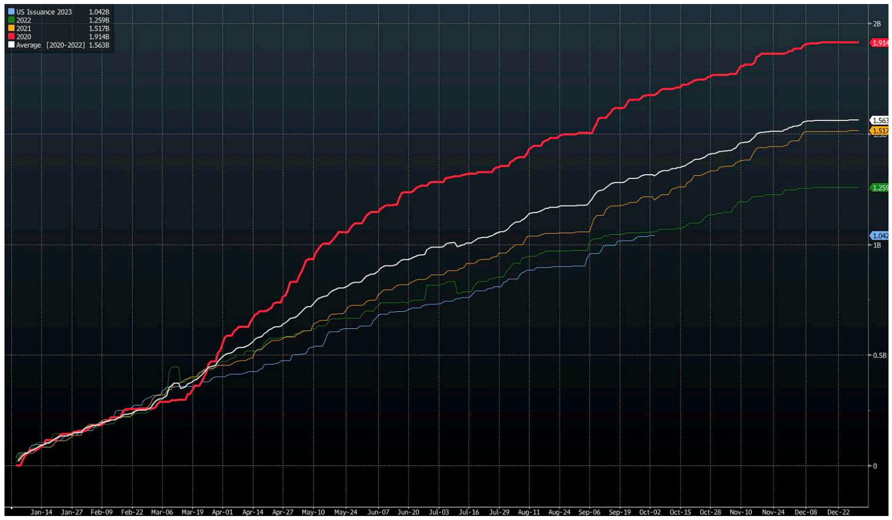
Source: Bloomberg, as at September 29, 2023.

In the US, the recent change in stance by the US Federal Reserve (Fed) has introduced additional uncertainty to the equation. Prior to the September FOMC meeting, investors had been anticipating a 100 basis points (bps) decline in the Fed Funds rate by 2024, along with a decline in the cost of capital across the yield curve (due to the inversion). **This had led to expectations that higher rates would have a negligible impact on corporate profitability, thanks to the wave of debt refinancing that occurred at favorable rates in 2020.**

Figure 8 shows the volume of US investment grade corporate bond issuance from year to year. The bold red line highlights the explosion of issuance in 2020, when the US 5-year Treasury bond yield was consistently around 25 bps. This compares to the current level of 4.7%! Clearly, US corporate were smart and disciplined in managing their balance sheets, refinancing huge amounts of debts at extremely low rates, securing cheap financings for the next few years.

Figure 8: US IG Corporate Bond Issuance

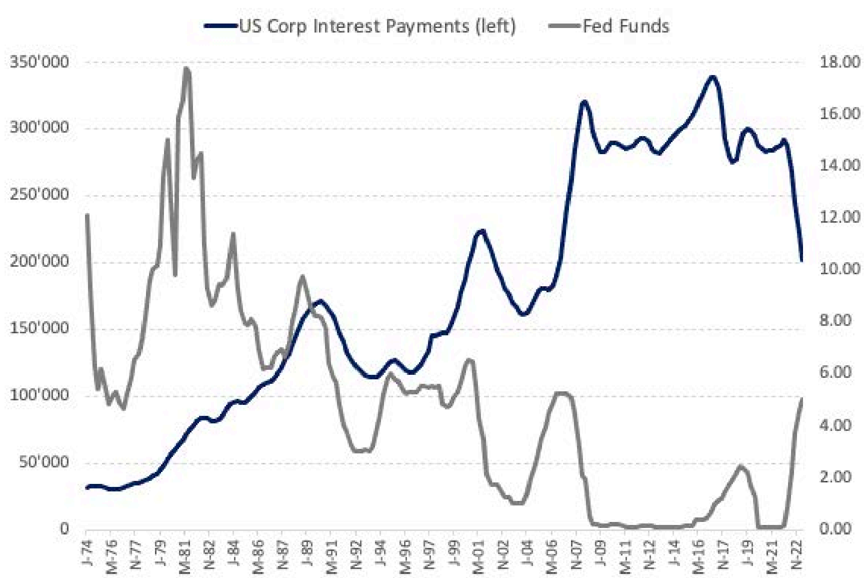
“Interest expenditures have actually declined over the past 12 months despite the Fed's cumulative rate hikes...”



Source: Bloomberg, as at September 29, 2023.

In the days before the recent FOMC meeting, the following graph had been widely circulated, explaining much of the resilience of US corporations, and indirectly the economy. In particular, interest expenditures have actually declined over the past 12 months despite the Fed's cumulative rate hikes (525 bps). The explanation for the dynamic can be attributed to the refinancing activity at very low rates.

Figure 9: US Corporate Interest Payments vs. Fed Funds



“In the housing market, there were signs of weakness even before the acceleration of rates to the upside.”

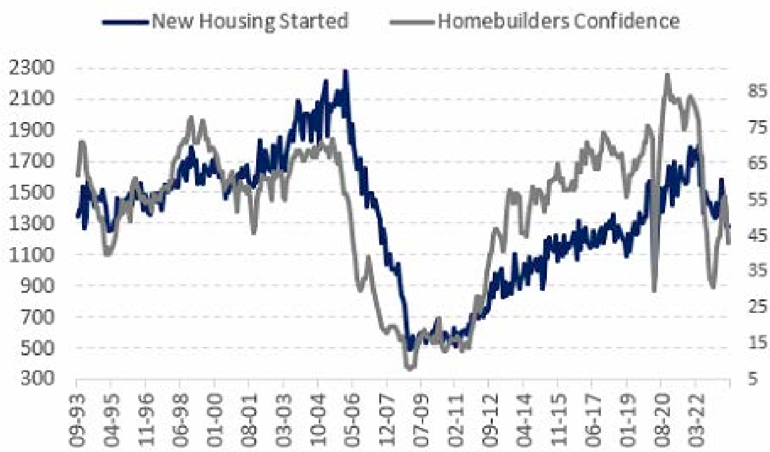
Source: Bloomberg, as at September 29, 2023.

The post-FOMC market stress and volatility can therefore be explained by this hypothesis: if rates remain high well beyond 2024, it is likely that upcoming maturities will not benefit from lower rates, but will have to be refinanced at higher levels. Indeed, the market is maturing with the idea that the next round of Fed easing—when it comes—will not be the kind of 300-400 bps of easing as it was in the past. **In fact, the market's projected Fed Funds rate low for the next three years stands at 4.29%, whereas only in the spring it was estimated to be below 3%.**

Another area of the economy worth paying attention to is the housing market. As indicated by both new housing starts and homebuilders' confidence, there were signs of weakness even before the acceleration of rates to the upside. "Higher for longer" may also imply less refinancing in the coming months—if not years—by households.

"It is difficult to foresee that in the year ahead fiscal spending will contribute as positively to economic growth as it did in recent months."

Figure 9: US New Housing Starts and Homebuilders Confidence



Source: Bloomberg, as at September 29, 2023.

Additionally, fiscal spending in the US played a crucial role in supporting strong economic growth in the early part of 2023. The government's three programs, including the Inflation Reduction Act, the Chips Act, and the Infrastructure Investment and Jobs Act, totaling at least USD1.6 trillion, contributed to both higher-than-expected growth and deficits. While it is impossible to forecast the path for fiscal spending, it is difficult to foresee that in the year ahead fiscal spending will contribute as positively to economic growth as it did in recent months.

Figure 10: Year-on-year Change in Government Expenses with Recessions in Shaded Grey

Source: Bloomberg, as at September 29, 2023.

"This approach implies that the Fed is more likely to raise rates if the economy remains resilient, even if inflation falls."

In Figure 10, the recent pattern is quite anomalous, as fiscal spending increased in a expansionary period (pro-cyclical).

The strength of the US dollar is yet another variable in the equation. At the start of this year, following a period of weakness that coincided with a stock market rally and US dollar decline, the US dollar began to strengthen again in July. This strengthening, coupled with a rise in interest rates, is leading to tighter financial conditions.

The yield curve has also steepened, with the 10-year yield increasing by 50 bps in September alone. The Fed appears to be adopting an asymmetric approach to monetary policy, prioritizing inflation control over preventing a potential economic downturn. This approach implies that the Fed is more likely to raise rates if the economy remains resilient, even if inflation falls. Moreover, as inflation is expected to decrease in the coming months, the real Fed Funds rate (the nominal rate minus inflation) may rise further. Rising oil prices are another concern, as they could push the Fed to consider further rate hikes to prevent long-term inflation expectations from becoming entrenched.

Figure 11: Nominal Fed Funds Rates Deflated by Headline CPI and 1-year Forward Inflation Swaps: The Coming Normalization in Inflation and the Tight Monetary Stance Will Automatically Push Real Rates Further Upwards

"It's worth noting that the long lags of monetary policy may start affecting the economy at an inconvenient time..."

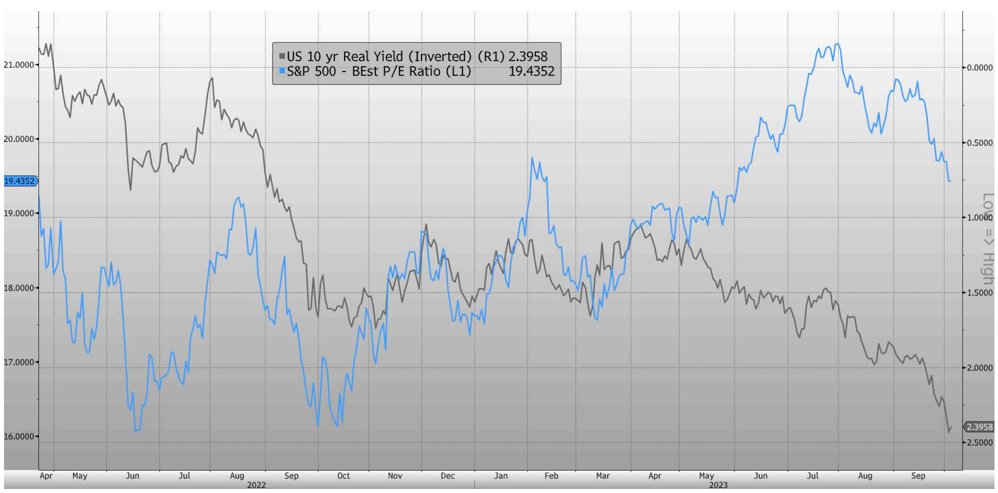
Source: Bloomberg, as at September 29, 2023.

In summary, a confluence of negative factors, including tight monetary policy, fiscal spending trends, a strengthening US dollar, and rising oil prices, is creating uncertainty in the economy and financial markets. It's worth noting that the long lags of monetary policy may start affecting the economy at an inconvenient time, potentially later than expected, coinciding with a no longer expansive fiscal policy.

The monetary dynamics described above are also putting S&P 500 valuations at risk. While corporate earnings have rebounded strongly over the past year, there has been a notable divergence between real interest rates and price-to-earnings (P/E) ratios. This divergence may need to be addressed, and with the Fed taking a hawkish stance, it's possible that part of the adjustment will fall on P/E multiples converging lower towards the high level of real rates.

Figure 12: A Notable Divergence Between Real Rates and P/E Ratios

"The monetary dynamics described above are also putting S&P 500 valuations at risk."



Source: Bloomberg, as at September 29, 2023.

Finally, the labor market will be a critical variable to watch. Signs of a slowdown in recent weeks may translate into a short-term decrease in employment, potentially providing the Fed with room to ease its grip on rates.

Given the US presidential elections in 2024, a further issue that could remain hot on the electoral calendar is that of the corporate-worker relationship market (which is now in the spotlight), with strikes by workers in the automotive and entertainment industries. It was striking that both Trump and Biden stood in solidarity with the workers, with Trump starting his campaign from Detroit instead of Florida as planned, and Biden attending a workers' picket in Michigan. If workers gain in labor power, this could put pressure on corporate margins, regardless of inflation trends. Indeed, it is hard to imagine that companies will have the strength to pass on higher costs to consumers a second time, as they did at the turn of 2022-2023.

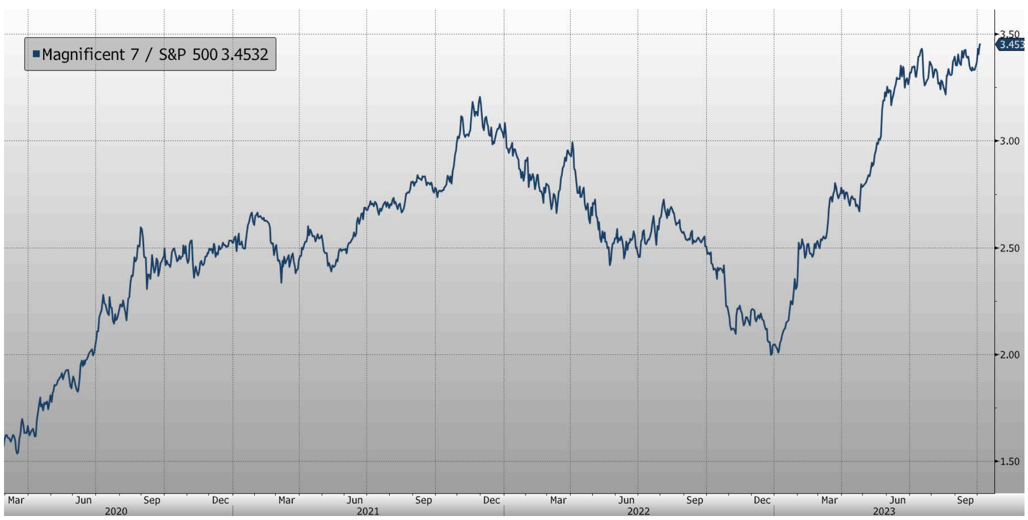
"It is hard to imagine that companies will have the strength to pass on higher costs to consumers a second time, as they did at the turn of 2022-2023."

Investment Strategy | Neutral US equities, defensive on Europe

Given the complex backdrop, we maintain the following market positioning: neutral on US equities and defensive on Europe. We are therefore maintaining a buffer so that we can increase equity exposure on weakness, helped by the fact that if markets were to fall, equity allocation would automatically be reduced, increasing the exposure to be restored.

We also think US megacaps deserve a special mention. As is clear from Figure 1, the Magnificent 7 are almost at their highest level since the market peak in January 2022 (-0.3%). Figure 13 shows the relative performance between the Magnificent 7 and the S&P 500 index. Consequently, a correct view on this relative performance in the coming months will be crucial for portfolio construction.

Figure 13: Performance of Magnificent 7 vs. S&P 500 Index



Source: Bloomberg, as at September 29, 2023.

We have analyzed the main variables of these stocks (through an arithmetic average), and compared them with the S&P 500 index (-10.74% from peak) and the Russell 2000 index (-21.46% from peak). What is striking is that the balance sheets of these stocks are healthy and lean , and particularly cash generative compared to stocks in the Russell 2000 index. In fact, the small Russell companies have a debt to earnings ratio almost double that of the S&P 500 (6.0 versus 3.7). Also, taking into account that small companies pay higher spreads on their debt, it is not difficult to explain the underperformance of small companies in an environment of high and rising rates.

"Expected earnings growth for the Magnificent 7 over the next 12 months, and the following 12, is almost double that of the rest of the market."

From the point of view of balance sheet quality, it is therefore clear that the Magnificent 7 have a huge advantage over the other indices. There are, however, two other key variables to consider: expected earnings growth, and valuations, as expressed by one-year forward P/E multiples. Expected earnings growth for the Magnificent 7 over the next 12 months, and the following 12, is almost double that of the rest of the market. Multiples are also higher, due to higher margins and expected earnings growth. The combination of high rates versus a possible hard economic landing will therefore be crucial in the coming quarters. Consistent with our view that an eventual recession should accelerate the decline of inflation and thus allow rates at the long end to fall, we believe that multiples should not suffer too much (supported by the inverse relationship with the descent of rates). As a result, the Magnificent 7, in our view, should confirm the trend in their favor.

"In September, accompanying the violent rise in yields, we decided to start building new positions by extending maturities."

Figure 14: Corporate Balance Sheets

	Mag 7 Avg	SPX	Russell 2000
Net Debt/Ebitda	-206,9	3,7	6,0
EPS t+1	19,09%	9%	10%
EPS t+2	22,29%	11%	11%
Estimate P/E 1y	27,9	17,5	18,9

Source: Bloomberg, as at September 29, 2023.

At an equity sector level, our portfolio construction maintains a slight overweight on US big tech. The other sector in which we are overexposed is energy. Apart from the fact that the price of oil seems to be well-supported by supply-side fundamentals, an energy price spike is a risk factor (and thus a hedge for us) for the performance of economies and markets.

As far as bonds are concerned, we have not been able to devote much attention to the asset class due to space constraints, but we limit ourselves to defining our activity over the past year—which fortunately has been extremely cautious and defensive. **At the beginning of 2023, we started building gradual exposure to the short end of the curve, through quality government and corporate bonds,** to benefit from attractive yields and highly inverted curves.

In September, accompanying the violent rise in yields, we decided to start building new positions by extending maturities. **With inflation coming down, economies slowing, and real rates now just below 3%, it seems to us that bonds are regaining some decent value, and that late 2023 and especially 2024 may finally be a favorable period for bonds both in absolute terms and relative to equities.** To provide some context, the 10-year US Treasury bond is down about 3% year-to-date, after being down 4% in 2021 and 18% in 2022. It has never happened that the asset has recorded three yearly declines in a row. We will only buy safe haven bonds, however, given our defensive stance on risky assets, we have some room to increase issuer risk on more attractive spread levels.

Strategic Views		
Asset	View	Action
US Equities	Neutral	Buy on weakness
EU Equities	Negative	No action
EM Equities / China	Neutral	No action
US Treasuries	Positive	Extend duration
EU Govies	Positive	Extend duration
Global Corporate Bonds	Neutral	No action
US Dollar	Positive	Reduce when Fed starts cutting

Vittorio Treichler
Chief Investment Officer

Flavio Testi
Senior Fixed Income Portfolio Manager

Daniele Seca
Senior FX, Crypto & Derivatives Portfolio Manager

Karim Khalil
Senior Equity Portfolio Manager

Carlos De Andres Perez
Senior Private Equity Funds Manager

Maxime Glasson
Senior Hedge Funds Manager

Julien Etaix
Senior Private & Direct Investments Manager

Giovanni Martinez
Senior Private & Direct Investments Manager