Prime Partners

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MARKET INSIGHT

JUNE 2022

CITYWIRE SWITZERLAND TOP 50 INDEPENDENT ASSET MANAGERS 2021

Market Analysis

June 2022

Searching for the equilibrium interest rate

Beyond the geopolitical context and Covid-19 containment measures taken in China – which obviously had an impact on financial markets in recent months – questions about interest rates have caused (high) volatility in financial assets since the start of the year.

First, there are questions surrounding the key rates the Fed intends to set in the medium term; we know that upward revisions of US Fed Funds forecasts have been a determining factor in the stock market correction since mid-January. However, investors have recently tempered their expectations in this regard.

There was also – if not most importantly – the bond crash, which reached its climax in the first few days of May. High volatility in fixed-income assets has also fuelled fears of an impending liquidity crisis, as well as erratic stock market fluctuations or the "bloodbath" that hit long-duration equities, in particular stocks in the technology and luxury sectors.

In response to the multitude of events we have faced over the past several months, we have always maintained that interest rates should remain the top priority in investors' thinking in 2022.

The concept of a neutral or "equilibrium" interest rate and how it is set continues to be a subject of contention, as there is no clear, magic formula for determining it. With no more "easy money" and the return of an interest rate environment that will no longer look anything like that seen during the 2010s, nervousness amongst investors is all the more understandable given that they have to "imagine" the global framework that will determine economic and financial developments over the next few years.

> "A return to calm in fixed income assets is undeniably necessary for equities to perform better."
>
> **FRANÇOIS SAVARY,** CHIEF INVESTMENT OFFICER, PRIME PARTNERS

The recent behaviour of financial assets reflects a real quandary: Market operators are searching for a neutral rate of interest that would enable the economy and markets to function less erratically.

This is made even more challenging by the fact that economic and/or financial figures – like a strong first-quarter earnings season – do not offer a clear picture. While the global economy is undoubtedly slowing down, it does not necessarily portend an impending recession or a lasting stagflationary drift.

Can global growth remain positive and satisfactory in 2022? We continue to think so.

Can inflation be partially normalised in the second half of the year? We remain convinced of it.

Without lapsing into unbridled optimism, we can refute the Cassandras predicting an "obvious recession" by pointing out that various leading indicators (the PMIs in particular) and the strength of labour markets in developed economies do not really support such an assumption - at least over the coming quarters.

In this respect, the improvement on the bond markets in May - after US 10-year yields hit the 3.20% mark - is an important development.

As such, following several months of outflows that impacted negatively on the bond markets, the decline in US 10-year yields to 2.75% (at the time of writing) seems to signal renewed demand for this asset class.

The simultaneous decline in bond volatility (MOVE index) should also be noted. This development happened in parallel to the stock market rally we witnessed in the second half of the month. A sharp compression in the P/E ratios

of developed markets equities since the beginning of the year may have prompted some investors to reposition themselves in the wake of reduced bond volatility.

In other words, we continue to believe interest rates should remain a primary concern. The changes seen in May offer some hope; however, they should not be considered definitive or irreversible.

Visibility on the economic cycle remains low, and clear signs are rarer than it would seem. US inflation over the next few months will prove particularly important; it must decline by the end of the year if we are to see a "sustainable" stabilisation of US 10-year yields around 3%.

Given an economic and financial environment still affected by multiple uncertainties, and after two erratic months for all asset classes, we have maintained the general guidelines of our tactical allocation.

We therefore still consider it justified to favour equities over bonds.

While excessive pressure on bond yields in April and early May prompted us to seize some opportunities, such adjustment was only marginal and did not change our determination to limit interest rate risk in portfolios.

Similarly, while some purchases of investment-grade corporate debt seemed appropriate, we have not altered our recommendation to continue managing duration prudently.

Generally speaking, and although it has been reduced, an underweight in bonds remains appropriate over the next three to six months.

In terms of equities, which are favoured in the asset allocation, exposure remains in line with our benchmark. Limited visibility on the economic cycle prevents us from taking a more aggressive approach, i.e. we are not increasing our exposure from neutral to overweight.

Admittedly, the rebound in late May might suggest that the correction is over, after indices flirted with "bear market" levels in recent weeks; valuation compression and heightened pessimism in the investment community are also arguments that could be used to justify a more aggressive approach on the markets.

However, we do not believe the conditions for taking such a risk have been met. We therefore prefer to keep our target allocation as a compass for the immediate future and to make tactical adjustments as required. In other words, at current levels the tactical equity allocation warrants neither a hasty increase nor a panicked reduction. This approach, which is by no means always easy to maintain, would seem appropriate in the economic and financial environment expected over the coming months.

From a currency perspective, we still expect the euro to rebound in the next few months. In this context, we were pleased by its recent recovery in the wake of a clear change of course by the European Central Bank (return to neutral key rates by the end of the third quarter).

We expect the EUR/USD rate to rise above 1.10 over the next six months, especially as political developments (like the mid-terms) may weigh on the US currency. A target of 1.15 by the end of 2022 is not unrealistic.

Similarly, the recent stabilisation in the price of gold seems to pave the way for an increase over the coming months. With less volatile rates, a weaker US currency and gold's "protective" qualities, the precious metal should be able to rise again past USD 1,900 in the medium term.

To conclude, changes in interest rates remain the central issue determining how the economy and financial markets will behave over the coming months. In early 2022 already, we surmised that this sequence of events (a major monetary shift coupled with a reduction in liquidity) would be decisive.

This assumption holds true as China prepares to lift Covid-19 restrictions, and with developments in Ukraine being very hard to predict.

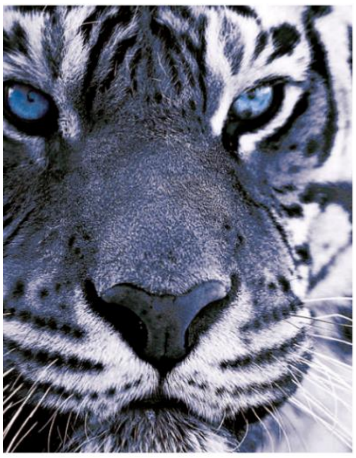
The recent stabilisation seen in bond yields is more than welcome, as a further return to calm in fixed income assets is undoubtedly needed for equity performance to improve.

We are pleased to see a decline in market volatility over the last few weeks, although we cannot ignore the fact that it remains high by historical standards and we certainly should not assume that a continuation of its recent trend is guaranteed.

While some recent economic data has "persuaded" investors that their recession fears may have been exaggerated and may have underestimated the possibility of inflation normalising in the second half of 2022, data released over the next few months must justify such an outlook. Only then can investors be sure

that we are approaching equilibrium interest rates, which will provide a steadier base for economic and financial markets forecasts 12 to 18 months out.

Geneva, 30 May 2022



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