CROSSINVEST

Wealth & Asset Management
Private Equity & Venture Capital
Family Office Services
Since 1985

Quarterly Outlook Q3 2022

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Dispersion Of Outcomes

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Recession versus Soft Landing

Three Key Market Drivers

Bear Market Rallies

Bear markets are often punctuated by sharp rallies before finding a bottom. This year was no exception as the S&P 500 staged a strong rally from their June 16 lows.

Inflation

Calls for peak inflation – and Fed hawkishness – on the back of declining commodity prices proved to be premature post Jackson Hole.

Recession

At the Jackson Hole symposium, Fed Chair Jerome Powell reiterated the Fed's commitment to restore price stability even if accompanied by economic pain.

Overview

The Fed Chair's acknowledgement that economic pain may be required to bring down inflation stands in marked contrast to prior rosy projections of a soft landing. While inflation may have indeed peaked, we remind investors that peak inflation is not necessarily low inflation. Inflation may have come off from the historical highs reached this year, but it is still a long way from the Fed's 2% target. While the broad commodity complex has declined, sticky inflation components such as wages and rents have proved to be far more persistent. The possibility of a wage-price spiral in the US has become a very real scenario. Although inflation expectations have remained relatively anchored compared to the 1970s when Paul Volcker had to raise interest rates to 20%, we find it difficult to envision inflation smoothly falling back to the Fed's target of 2% when the Employment Cost Index is at 5.1% and Owner's Equivalent Rent is at 5.8%. Our base case is that it is likely to take a recession in order to restore price stability. We highlight that double digit rallies were common in previous bear markets and would recommend investors to sell any rally in risk assets before we can see a sustainable drop in inflation to acceptable levels.

Bear Market Rallies

Bear market rallies were a common phenomenon in previous market downturns. Market participants conditioned to buy the dip may be mistaking extrapolation for analysis. While the Fed has rode to the rescue for much of the past several decades, we believe high inflation would encourage the Fed to err on the side of hawkishness this time around.

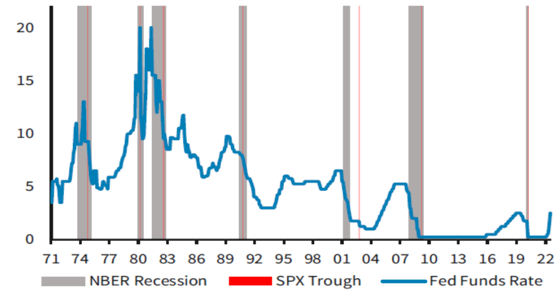
Despite deteriorating economic conditions, the S&P 500 staged a furious double-digit rally off its June 16 lows. This was sparked by a multitude of factors including short covering, extreme bearish positioning and hopes of a dovish pivot by the Federal Reserve. We felt this was premature as the sticky components of inflation had yet to abate to levels that would enable the plausibility of the Fed achieving their 2% target for inflation. Also, valuations were far from attractive and did not offer adequate compensation for risk, in our view. The price to earnings ratio for the S&P 500 has touched 15 in the previous 2 market downturns and was hovering at the 18 handle even before the summer rally occurred. Since then, the market has returned most of its gains.

A key reason for our disbelief in the summer rally was that it runs counter to the Fed's policy goals. A rally in risk assets would lead to an easing of financial conditions, which would stoke inflation even further. Even if a decline in commodity prices has led to an easing of inflationary pressures, it is still running far too hot and labor markets too tight for the Fed to back off quickly. We are of the opinion that wages and rents are the critical components that need to see significant declines for inflation to cool to the Fed's target of 2%. The key question is whether a recession be required to do so, or would a soft landing be possible. A study of history and the Fed's track record tilt the risks towards the former.

We do not rely on valuations alone as cheap things can become cheaper. A poignant example would be emerging market assets. Valuations are currently very cheap; with many central banks having pre-emptively raised interest rates to fight inflation last year. However, they remain vulnerable to USD strength. With the Fed being the most hawkish central bank in the developed world, we stay on the sidelines until the USD has peaked.

We believe that the old Wall Street adage that "nobody rings a bell at the top or the bottom of any market" still holds, and strenuously try to avoid timing the market. Rather, we look for mispriced assets and construct portfolios that offer an attractive risk to reward profile. Given the wide dispersion of outcomes in today's environment, we prefer to be late rather than early in calls of peak inflation or market bottoms and adhere to the notion that discretion is the better part of valor.

Equities didn't trough before the Fed cut rates

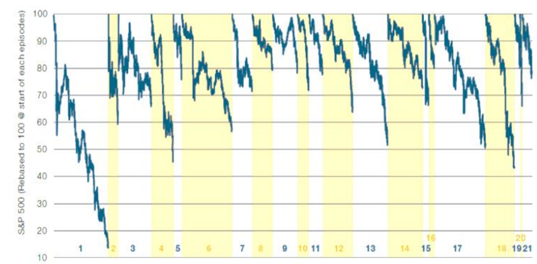


Source: Barclays

EM and USD share an inverse relationship

Source: Fidelity International

Double-digit rallies were common in bear markets



Source: Man Group

Inflation

In the debate about inflation, we are neither of the view that we are about to return to a regime of structurally high inflation such as the period in the 1970s, nor that inflation will transit smoothly to the Fed's target of 2%. Rather, our view is more nuanced and cognizant of both sides of the debate. A strong US dollar, relatively anchored inflation expectations, peaking commodity prices and declining energy intensity within the economy make for a compelling case for inflation to drop off from the historic levels reached this year.

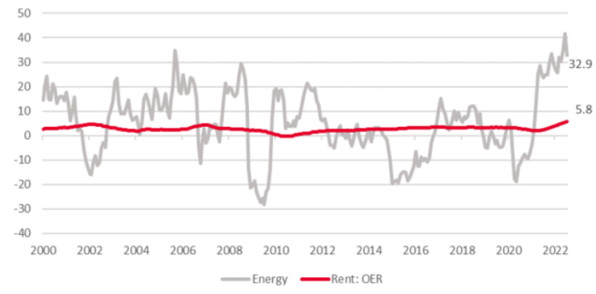
Unfortunately, the Fed's error in easing monetary conditions in 2021 has allowed the possibility of a wage price spiral to seep into the economy. Also, rents account for approximately a third of core inflation. With wages and rents staying elevated, we believe that it is unlikely for inflation to reach 2% soon. While the Fed may express "unconditional" commitment to price stability when the labor market is strong, we highlight Jerome Powell's track record of missteps and flip-flopping. The labeling of inflation as "transitory" was an error of gargantuan proportions, and as recently as March the Fed Chair was expressing confidence in a soft landing.

We believe the Fed's real challenge will be when the labor market finally cools, and its dual policy objectives become a trade off. If inflation was falling not to 2% but to 4%, but the unemployment rate has crept higher to above 5%, what would the Fed do? In such a scenario, the Fed would be left with no good choices. It also remains to be seen if the Fed will be willing to endure the pain when it truly comes, especially with a slowing housing market, high levels of sovereign debt and unintended consequences of quantitative tightening lurking in the background.

Inflation across the Atlantic is a different story. Furlough arrangements has meant that the Eurozone has not seen searing growth in wages. Indeed, much of the inflation in the Eurozone is supply driven, in our view. This is largely caused by disruptions in energy as a result of Russia cutting off supplies. While the European Central Bank (ECB) has shifted to a hawkish stance, monetary policy cannot print oil. Economic fragility in eurozone peripherals also mean the ECB must try to cut it both ways; to prevent the spreads of the debt of these countries from widening too much and trying to tame inflation at the same time.

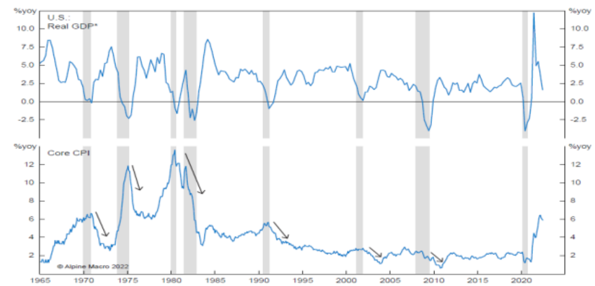
We are monitoring Eurozone assets for the possibility of an unexpected resolution of the war. Energy shortages across many Eurozone countries have shifted incentives towards an armistice. Unless this comes to pass, we remain bearish on the Euro as well as peripheral debt, as the former continues to be vulnerable against the dollar and the latter trades more like risky credit than safe-haven assets.

Inflation drivers – Energy vs rent



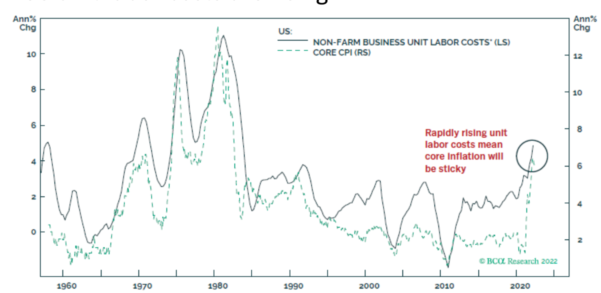
Source: Société Générale

The Fed is willing to risk a recession



Source: Alpine Macro

US unit labor costs are rising



Source: BCA Research

Recessions

Market narratives has shifted markedly in the last quarter as pundits shifted their focus on the probability of a recession to the timing of a recession. While the US has entered a technical recession – defined as two consecutive quarters of negative growth – a strong labour market has left many analysts projecting a recession to arrive next year. Sir John Templeton has rightly noted that the four most dangerous words in finance are "This Time It's Different". Many recession indicators are currently flashing warnings signs, from inverted yield curves, the Conference Board's Leading Economic Index (LEI) and the copper to gold ratio.

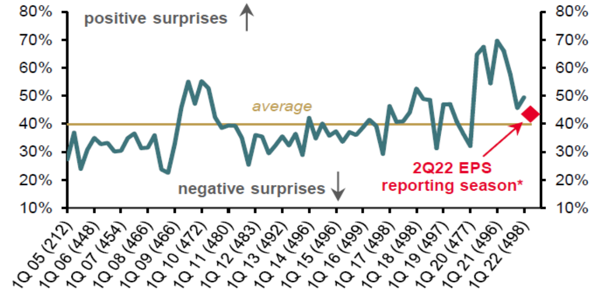
Our view is that the risk to reward profile on equities and credit is not attractive and thus remain underweight both asset classes. Firstly, it is likely that the Fed will have to engineer a recession to restore price stability, especially as the Fed has abandoned pretense on the possibility of a soft landing. Secondly, valuations across equities and credit remain overly optimistic that falls short of pricing in recessionary risks. Third, risks of financial accidents from unintended consequences abound. Lastly, we prefer to be late than early in any risk on rally as the downside risks are elevated and upside limited.

The Fed's previous quantitative tightening program in 2019 had to be abandoned after the plumbing of the financial system clogged up and overnight borrowing costs skyrocketed. This came after then Fed Chair Janet Yellen said the process would be so predictable it would be like "watching paint dry". What makes us nervous is that the Fed will be attempting quantitative tightening on an even more aggressive scale starting from September at $95 billion a month.

Given our focus on downward protection, we have started to layer recession hedges across our portfolios. We remain disciplined in our position weights and express our views via a diversified mix of positions. We are neutral on duration, overweight on gold, hold derivatives that offer compelling risk reward should the US dollar turn, as well as being underweight equities and credit.

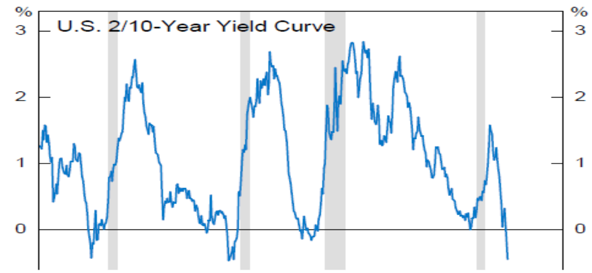
The next downward leg in risky assets may come from a decline in earnings as profit margins fall from historical highs. With the exception of energy companies, earnings beats have started to inflect downwards. While equity multiples have certainly contracted, an earnings recession has yet to be priced by the market. We would be more positive on risky assets if there were to be a bottoming in downward revisions to corporate earnings forecasts, adequate compensation for risk, signs that monetary tightening is sufficient to bring inflation back to central banks' targets, or a dovish pivot.

Historical EPS breadth of surprises



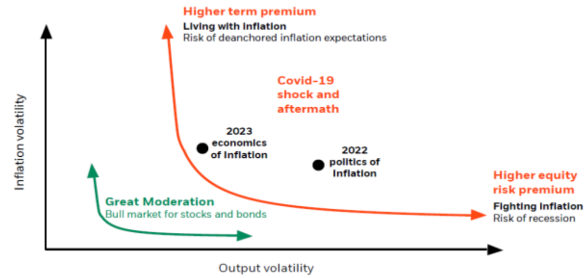
Source: Société Générale

Recession odds are rising



Source: Alpine Macro

Worsening trade-off for central banks



Source: Blackrock

Key Calls

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Looking Forward

We remain cautious and are underweight risk assets across equities and credit. We have adopted a neutral stance towards duration but only towards US Treasuries. We are not positive on Bunds given unattractive relative value. We have reduced our position in Chinese assets given inflamed international tensions in the wake of Nancy Pelosi's visit to Taiwan.

- While we remain underweight equities as an asset class, we remain overweight quality within equities
- We have raised our allocation to assets and derivatives with attractive risk reward profiles in the event of a turn of the US dollar.
- We remain underweight credit but may add to portfolios if credit spreads were to widen to attractive levels.
- We are structurally positive on energy although we have taken profits in a tactical trade. We look for attractive points for re-entry.

Our current views are as follow

- United States: Underweight – US equities are the most expensive globally while the Fed is the most hawkish central bank globally.
- Japan: Slight Overweight – Attractive valuations and globally competitive franchises make for a small overweight.
- Developed Europe: Neutral – Cautiously optimistic due to undemanding valuations and potential for positive Black Swans.
- Asia ex Japan: Neutral – Commitment to Covid Zero policies by China for political reasons make disentanglement unlikely.
- Emerging Markets: Underweight – While valuations are attractive, they remain vulnerable to further strengthening of the US dollar.
- USD Rates: Neutral – We are neutral on US duration as recessionary risks have become elevated.
- DM IG Credit: Underweight – Flattening credit curves mean that we move up the credit curve for more attractive valuations.
- DM HY Credit : Underweight – We are reducing HY exposure as we believe markets are too sanguine about a slowing economy.
- EM Credit: Neutral – We stay away from EM due to USD strength and note they remain vulnerable to a slowing of global trade

About Us

We are a privately-owned financial institution, with over 35 years of Swiss heritage that exemplifies the finest wealth & asset management traditions.

Our key business areas are asset & wealth management, private equity & venture capital and family office services. We work exclusively with high & ultra-high-net-worth individuals, families and institutions.

As an award-winning independent asset manager, we are keenly aware of the importance of considering the cross generational impact of investment and wealth-management decisions.

We appreciate that every client is unique, and every need is different. This leads us to create tailored solutions to meet our clients' goals while maintaining institutionalized processes of asset management.

Our Mission

Our clients' wealth is the result of the time they sacrificed away from their families to ensure their financial security; it is our mission to protect and build on this sacrifice.

We achieve this through

- Establishing long-term relationships
- Our independence
- Operating as a dedicated fiduciary advisor
- Our commitment to provide the best investment solutions & services
- Crafting the best solutions for our clients' individual needs

CROSSINVEST AWARDS

CROSSINVEST

2021

Rising Star for Asia-Pacific

Best Multi-Family Office Singapore 2021

Best Independent Wealth Manager Singapore 2021

2020

Best Asset Manager Serving Family Offices & Private Banks

Best Next – Generation Offering – Highly Commended 2020

HIGHLY ACCLAIMED OUTSTANDING INDEPENDENT WEALTH MANAGER – OVERALL

WINNER BEST ASSET MANAGER OVERALL

2019

Outstanding Contribution to Wealth Management

Best Discretionary & Advisory Offering

Best Client Experience Overall

Outstanding Independent Wealth Manager & Client Experience

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