B Capital SA
Rue Jean-Calvin 14
1204 Geneva
Switzerland

Tel +41 22 317 7823
Fax +41 22 545 7714

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B Capital Commentary and Outlook Update 2H2022

Equity markets suffered significant falls in the first half of 2022 as investors faced a worsening economic and geopolitical situation that drove the MSCI World Index down by -20.9%. The primary concern has been rocketing inflation that now requires stronger than expecting monetary policy actions by central banks around the world. In other words, rate rises and at an unexpectedly faster pace than anyone had thought possible after two years of pandemic lockdowns and muted business activity.

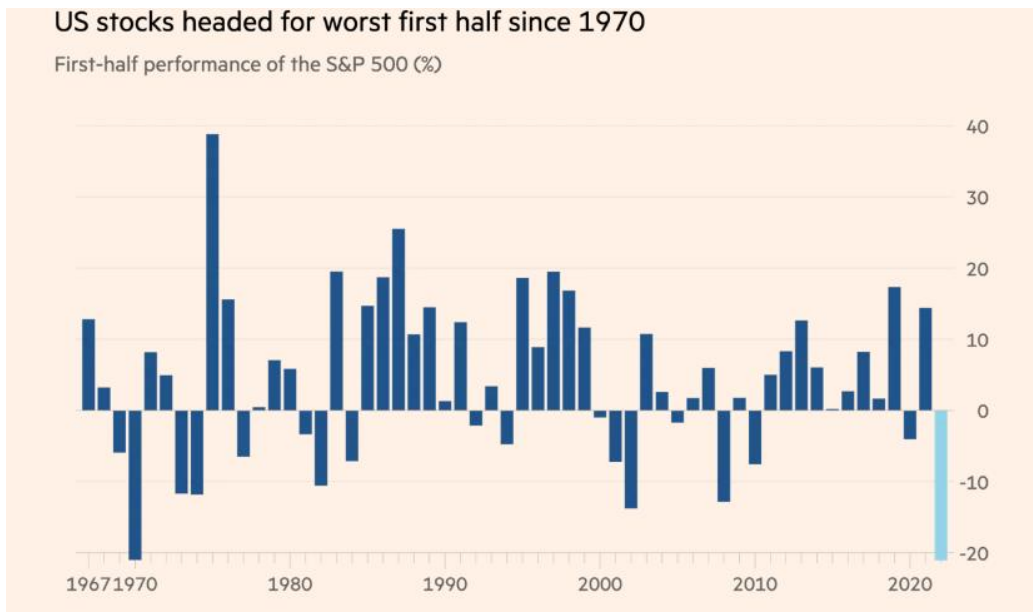

Fig 1 - The S&P500 Index - First Half Performance 1967-2022
Source: Financial Times

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The forecasts for higher but temporary inflation were simply wrong but it wasn't just the central bankers who missed their targets by a country mile, it was in fact pretty much everyone. Demand after the release from confinement has been strong while supply chains are showing their fragility and inelasticity caused by bottlenecks and component shortages.

Add in an incursion by Russian forces into Ukraine that quickly became a full-blown invasion and the twin economic and geopolitical risks sent investors scurrying for safety. But where was the safe haven that could give portfolios protection when stocks are pushing into a bear market? With interest rates suddenly rising faster than predicted, the bond market was also impacted. The global aggregate index fell by -12.3% giving no protection to the classic portfolio mix of equities and bonds, and longer dated issues dropped by as much as the equity markets. The standard balancing approach didn't work, wrongfooting most models to some extent and making the first half of this year a surprisingly difficult one to unpick.

When inflation is soaring and the economy is likely to head into recession an alternative source of returns and protection can be found in gold. The store of value theory is often cited by goldbugs and indeed the precious metals asset class can often perform well when politics brings added risk. 2022 should therefore be a perfect year for owning gold to hedge stock volatility and to react to inflation concerns. It has the potential to help a portfolio through big upheavals in other asset classes and this may be more evident in the second half of the year. The only real hedge in the short term has been the US Dollar, which has appreciated strongly as positive interest rates suck cash from other currencies and punish anything that doesn't have a comparable yield. 'King Dollar' as it has been dubbed, has trampled over other currencies and has held precious metals prices back, so far.

With a war on its eastern flank and slower growth coupled with a higher unemployment rate, Europe is more vulnerable as the second half of the year begins. This is manifesting in the currency of both Europe and the UK as the region grapples with multiple headwinds simultaneously. Unlike the US or China, Europe has an additional problem this coming winter, as Russia may cut off the gas and oil supplies in reaction to military support being provided to Ukraine. It is possible that already high energy prices spike higher if Vladimir Putin decides to use his country's vast mineral supplies as a tactical weapon. That would be a significant event and it is somewhat hard to predict because no-one, not even Putin's own generals according to intelligence reports, know what he plans next.

Without wishing to overly laden doom onto gloom, there is a further risk that has developed in the first half of 2022, and that is a slowdown of the Chinese economy which is impacting the largest property developers. This has been brewing for a while and the Evergrande crisis has been flagged already, but it's worth noting that indebted property developers are the canary in the coal mine at the start of a serious slowdown in any economy. China's property sector accounts for about one-third of total output in the world's second-largest economy. The industry's prolonged downturn was a significant reason, alongside rolling Covid-19 lockdowns across the country, that growth slowed to just 0.4% year on year in the second quarter. The PBOC has announced a plan to mobilise some $148Bn of new low interest loans to commercial banks to prop up the sector. This may avert a crisis but slowing growth across the broader economy is likely.

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MEMBER SWISS ASSOCIATION OF ASSET MANAGERS (SAAM)

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Are we headed for a recession and stagflation? The need to cool inflation has become the clear driver of hawkish briefings by the world's central bankers. The worry of recession has now largely become an acceptance that growth rates will be negative in the US and Europe for more than a couple of quarters, thereby fulfilling the criteria of a recession. To our mind a technical recession does not have to be a reason to exit stocks, so long as it is mild and short in duration. We look at earnings and the forecasts from companies' management to take a steer on the future for the economy, combined with macro data including interest rates and fiscal policies. After all, the world's largest companies revenues reflect what is happening on the ground and managers can guide us to efficient capital allocations.

In the US, where we have maintained an overweight stance for some time, we expect earnings growth of 9.2% for Q3 2022 and 8.7% for Q4 2022. For the whole of 2022, we are predicting earnings growth of 9.8%.

The forward 12-month P/E ratio is 16.7, which is below the five-year average (18.6) and below the 10-year average (17.0). However, it is above the forward P/E ratio of 15.8 recorded at the lows in late June, as the price of the index has increased while the forward EPS estimate has decreased (slightly) in July. The dividend yield is 1.69%. We expect inflation to level off and eventually fall as we head into 2023 and if a recession is under way it will be mild thanks to stronger household and corporate balance sheets combined with unemployment at below 4%.

Despite the pain of the first half of the year, it is likely that equities have largely priced in a recession and that should inflation peak and then start to ease so too will the fears over high interest rates subside. This will give a boost to equities broadly and some sectors that have been strongly affected by higher rates (ie technology) may see the quickest return to the trend line. It may be premature to call the bottom to the market but as we have written recently, markets are supported by earnings and the forward-looking price ratio to those earnings is not expensive even if earnings revisions come down. We could see a little optimism creeping back after the gloom, and a better second half of the year that might redress the negatives of the first half.

Lorne Baring
Managing Director

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