

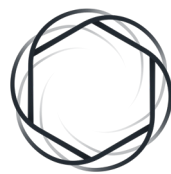


S.P. HINDUJA

BANQUE PRIVÉE

# House View

NOVEMBER 2022



## Thoughts of the CEO

“The market is reassessing the sustainability of government debt.”

The U-turn on the UK’s “mini” budget has significant implications for the further development of economic policy in the industrial nations. If our assumption is correct, it will leave deep traces in the real economy and on financial markets.

The policy blunder not only severely damaged the confidence of the financial markets in the reasonableness and soundness of a leading economy’s fiscal policy, but the sharp fall in the value of an asset previously considered “safe” – UK government bonds – spilled over into the pension and mortgage markets. Within the first days after the spike in bond yields, some British banks had reported that they would not be able to grant new loans in view of the volatility in the interest rate market. The UK is fortunate, then, that a threatening financial crisis could be calmed so quickly by the Bank of England and by a mere government U-turn.

Yet, one needs to also consider that the Bank of England’s emergency bond-buying firehose increased the base money supply at an inopportune time. This was in clear contradiction to the central bank’s stated monetary policy: tightening monetary policy to combat consumer price inflation, which at times this year exceeded 10 per cent.

In the UK we thus reached a situation where fiscal policy forced monetary policy to change course, at least partially, at least temporarily. Such an eventuality was always held up as the risk case scenario of what could happen if there were too much government debt, namely, that central banks might not actually be able to raise interest rates to the level required to deal with inflation. Now we see that in a G7 country, fiscal policy forced monetary policy to partially reverse course, but then that same fiscal policy had to be reversed itself.

There is an added dimension here. For as long as government bond yields are below the rate of inflation, they represent a loss in real terms. The risk, then, is that further government deficits might have to be financed directly or indirectly by the buyer of last resort – the central banks – because on a particular day, the market might no longer be willing to absorb those deficits. The phenomenon observed in England is probably not going to be an isolated case, which is why we seek to understand its potential implications.

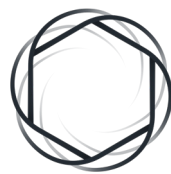
In the chart on the next page, we compare the levels of government indebtedness in the UK, the eurozone, the US and Switzerland since the introduction of the euro. The UK, which had the lowest level of government debt in 1999, now has the highest, as a percentage of GDP. What this highlights is how fortunes can be reversed. Policy can deteriorate gradually, over a long time, until the market suddenly notices the elephant in the room.

Announcements of big new fiscal packages in the US, the eurozone and elsewhere might now lead to new challenges to central banks: do they act as buyer of last resort or do they focus on their inflation mission instead? We can now no longer take for granted that central banks have free reign to do what is necessary to bring inflation back to 2 per cent as soon as they can. While we think that inflation may now have peaked and may soon be heading lower, we also think that we should probably expect higher average inflation for longer. The UK has done investors a favour by shining a light on a major fault line in our world of highly indebted governments.

Yours sincerely,

Karam Hinduja





# Investment positioning

In the next three months or so, we expect to see evidence that inflation has peaked and is heading lower. If that materialises, markets will have a better sense of the new likely ceiling for interest rates. US Treasury bond yields are currently more attractive than the yields offered by highly-rated non-USD alternatives. As for equities, the investment environment remains challenging. We, therefore, continue to recommend our clients to maintain a defensive portfolio positioning.

## When is the time to pivot to equities?

Despite the sell-off in the markets, and the lower valuations, opportunities are only emerging very selectively. The environment remains difficult for all asset classes.

While equities have become markedly cheaper, monetary policy is still tightening, keeping the environment for equity investments difficult. Moreover, data suggests that the economic trend is still weakening. This means that corporate profits, which are currently growing only moderately, will face even stronger headwinds.

What does the historical data suggest is the best time to pivot to equities? Figure 2 shows the history of US central bank interest rates (in the upper half) and the losses on the US stock market (in the lower half). In the eight interest rate cycles since 1970, the US equity market has generally bottomed out after the central bank had already started cutting rates, with the only notable exception being 2018. In that case, the expectation was that the central bank would

sooner or later abandon its policy course, allowing the stock market to stabilise before the interest rate peak. The crucial difference though was that the US economy was on the upswing at that time and inflation was not a problem.

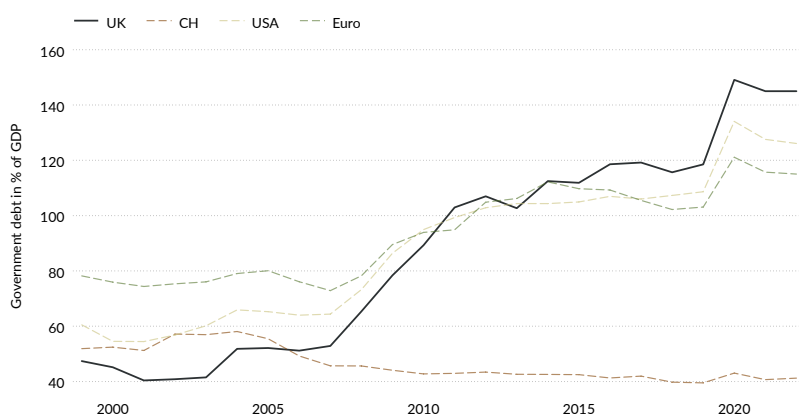
Accordingly, we believe it is prudent to await greater clarity on the likely ceiling in US interest rates, which we hope will become evident soon from the inflation numbers.

## US bonds in a currency dilemma

US bonds now offer more attractive interest rates in more areas across the curve. And a poorer economic outlook would tend to argue for US Treasury bonds. This may be fine for US dollar-referenced investors. But for investors referenced in some other currencies, such as in euros or Swiss francs, higher policy rates by the Federal Reserve than in the euro area or in Switzerland means that currency hedging has become very expensive and erodes the higher yield on offer from US bonds. As we have pointed out on

**Fig. 1: Government debt relative to national income**

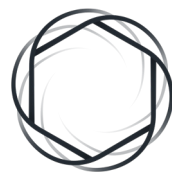
Development of government debt as a percentage of GDP since the introduction of the euro



SOURCE: OECD, WPULS

The chart shows the development of government debt as a percentage of national income since the introduction of the euro. Particularly outside Switzerland, government debt has risen massively. The development in the UK is also striking. In 1999, the UK had the lowest level of indebtedness on this measure in comparison to countries and regions shown. But today they are at the top. Just since the Global Financial Crisis, public debt there has risen by 100 per cent of national income.





several occasions, foreign investors need to consider that the US dollar will not always stay strong. In Europe, the opposite is true: while the cost of currency hedging is low, we do not yet consider the interest rate attractive enough to buy the highest quality eurozone government bonds. We, therefore, recommend maintaining an underweight for foreign government bonds.

### Money markets more interesting again

On 2 November 2022, the US Federal Reserve raised the federal funds rate to 3.75-4 per cent. The accompanying statement said that the Fed “anticipates that ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 per cent over time.” Another one or two hikes could take us to around 5 per cent, therefore, a level last seen sixteen years ago.

Against this background, more US dollar-referenced investors are interested in benefitting from rising interest rates at the short end. One way to benefit is via money market instruments into high-quality, short-term debt instruments. We would be happy to discuss potential options with you.

As pointed out above, investors whose benchmark is not the US dollar, but a currency that is likely to appreciate against the US dollar, need to consider money market opportunities that make sense for their respective portfolio.

### The difference to cash

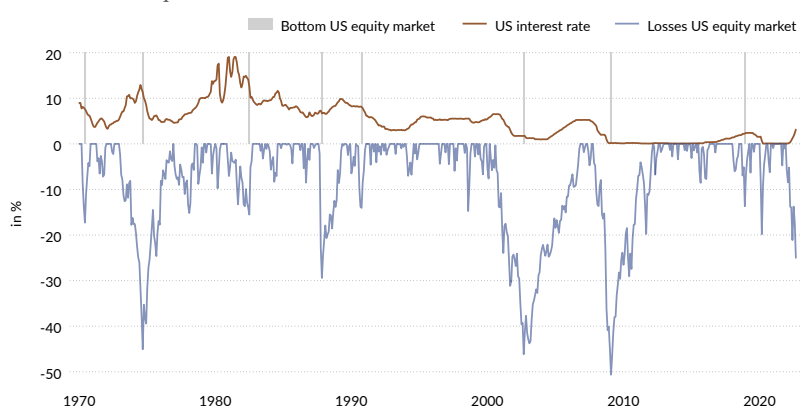
Money market funds are a type of mutual fund that usually invest in high quality, short-term debt and/or cash instruments. Though not as safe as cash, these funds have extremely low risk and generate income rather than capital appreciation. The aggressive tightening policy by most of central banks during 2022, has significantly increased the attractiveness of this asset class. Money market funds have become an interesting alternative to be used as a parking place for cash between periods of investments or trades and provide a higher income when compared to bank savings deposits which are yielding an average of 1.1 per cent.

Yields on money market funds are today averaging 2.80 per cent, up from 0.22 per cent in January – levels last seen prior to the great financial crisis. Yields follow the Fed and their visibility is extremely high. Therefore, assuming the Fed keeps raising its benchmark rates, money funds could soon consolidate their yields above 3 per cent. High liquidity and safety are main attributes of money market funds. The financial instruments that make up these funds are considered into cash quickly at any time and their average maturity usually ranges between 90 to 150 days. In addition, they exhibit less volatility and are less prone to market fluctuations and interest rate risk than longer-duration corporate bonds.

As of 2 November, assets in US money market funds stood at USD 4.63 trillion, split into institutional (65 per cent) and retail (35 per cent) (Investment Company Institute).

**Fig. 2: US equity market losses and US interest rates**

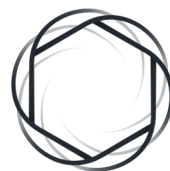
Performance comparison of the S&P 500 and the US Federal Funds rate



SOURCE: REFINITIV, WPULS

This chart compares the performance of the S&P 500 with the US Federal Funds rate. In the eight interest rate cycles since 1970, the US equity market has generally bottomed out after the central bank had already started cutting rates, with the only exception being 2018. In that case, the expectation was that the central bank would sooner or later abandon its course, allowing the stock market to stabilise before the interest rate peak. Crucially, the US economy was on the upswing at that time and inflation was not a problem. The current environment is less supportive.



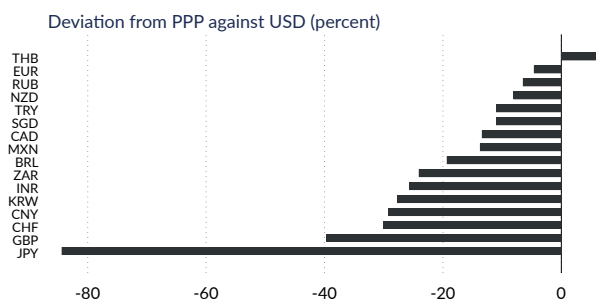
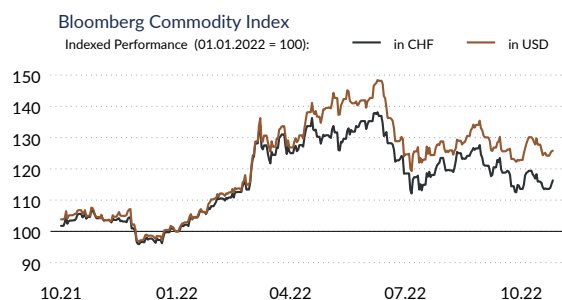
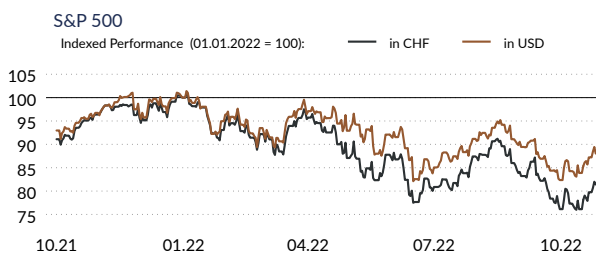
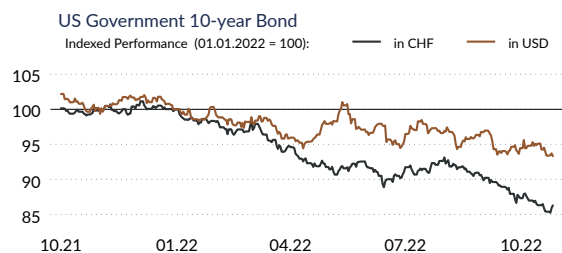


## Macroeconomic estimates (in %)

	GDP Growth			Inflation		Interest Rates	Money Growth M1
	Trend	2021	2022E	2021	2022E	Q3 2022	y/y 10/2022
<b>USA</b>	1.6	5.7	1.0	4.7	7.0	4.0	3.5
<b>Eurozone</b>	1.0	5.3	2.0	2.6	8.0	2.0	7.1
<b>UK</b>	1.7	7.4	2.5	4.0	9.0	3.0	8.1
<b>Switzerland</b>	1.4	3.7	2.2	0.6	2.5	0.5	2.7
<b>Japan</b>	1.1	1.7	1.5	-0.2	2.0	-0.1	5.5
<b>China</b>	4.5	8.1	3.5	-1.6	2.5	3.65	6.4
<b>Brazil</b>	1.2	4.6	0.0	8.3	11.0	13.75	-7.7
<b>India</b>	5.0	8.3	6.0	5.1	7.0	5.9	9.2
<b>Russia</b>	–	–	–	6.7	–	7.5	15.6
<b>World</b>	2.9	6.1	2.0	4.7	7.0	–	–

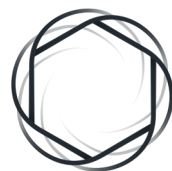
SOURCE: REFINITIV, WPULS

## Financial Markets



SOURCE: REFINITIV, WPULS





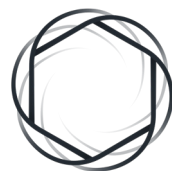
## Global Asset Allocation Preferences – November 2022

“Still defensive, as we wait for more evidence that inflation has peaked.”

Asset Class	View	Constituents	We favour	We avoid	Commentary
Cash	++				Temporarily increase cash for defensive profiles in times of heightened uncertainty and risk aversion. Money market instruments becoming more attractive to generate yields.
Fixed Income	+	Segments	Treasuries, investment grade credit.	Convertibles, High Yield, Emerging Markets.	While we expect volatility to continue in the short-term, our sentiment is that interest rates are approaching their peak in the current tightening cycle. Nominal rates likely to remain high in the near-term, making better-rated fixed income investments look more attractive relative to risk assets.
		Duration	Short- / medium-term.		In view of higher yields, we are starting to develop a more constructive view on medium duration. For investors with specific income targets, we are starting to see attractive yields in the medium part of the curve. Reach out to us for advice on how to balance duration risk and income generation in your portfolios.

VIEW: ++ VERY ATTRACTIVE + ATTRACTIVE = NEUTRAL – UNATTRACTIVE — VERY UNATTRACTIVE





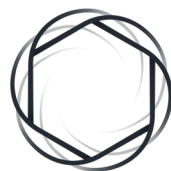
## Global Asset Allocation Preferences – continued

“Still defensive, as we wait for more evidence that inflation has peaked.”

Asset Class	View	Constituents	We favour	We avoid	Commentary
Equities	–	Markets	U.S.	Europe, Emerging Markets.	Central banks’ determination to bring down inflation increases the odds of a global recession. Europe more vulnerable given high energy costs. US less exposed to energy inflation and supported by strong USD. Within EM, we have a preference for faster-growing India and its positioning in the geopolitical landscape.
		Themes	Quality value. Dividends. Consumer staples, health-care and agricultural stocks.	Highly levered, long duration and cyclical equities.	Focus on companies with strong earnings resilience featuring pricing power, high margins, and low leverage. Value stocks generating real cash flow. Dividend growth.
Alternatives	+				Looking for potentially uncorrelated assets, hedges from inflation, and steady cash-flow.
			Selected REITS, listed infrastructure, gold.	Distressed debt, private debt, consumer lending.	We recommend holding some gold in the portfolio.  We are neutral on carbon credits as we weigh the positives (more use of coal) and the negatives (economic slowdown, leading to lower energy use).

VIEW: ++ VERY ATTRACTIVE + ATTRACTIVE = NEUTRAL – UNATTRACTIVE — VERY UNATTRACTIVE





## Figure of the Month

# -75%

The EU reference wholesale price of natural gas futures linked to the “Dutch TTF”, declined by three-quarters from its peak of 339 EUR/MWh at the end of August to 85 EUR/MWh at the end of October (Source: Trading Economics). While this has brought relief to Europe, natural gas can only be stored or consumed. If storage is almost full and temperatures are mild (gas is not consumed), the price needs to come down to keep the balance between supply and demand. Note that the current TTF price is still significantly higher than the 10-16 EUR pre-pandemic level. However, it provides hope that Europe will see through the winter with sufficient gas.

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Founded in Geneva in 1994 by Srichand Parmanand Hinduja with a vision to provide clients with a bridge between East and West, our institution remains the only Indian-owned Swiss bank in history. With an active presence in Switzerland, India, UAE and the UK, S.P. Hinduja Banque Privée offers its clients the reliability of Swiss regulatory oversight, while providing specialized access to high-growth markets.

We are a private bank with an entrepreneurial spirit, embracing collective action and building creative solutions that advance the world, economically and socially.

*The future of banking is emerging at the intersection of profit and purpose.*

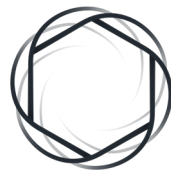
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