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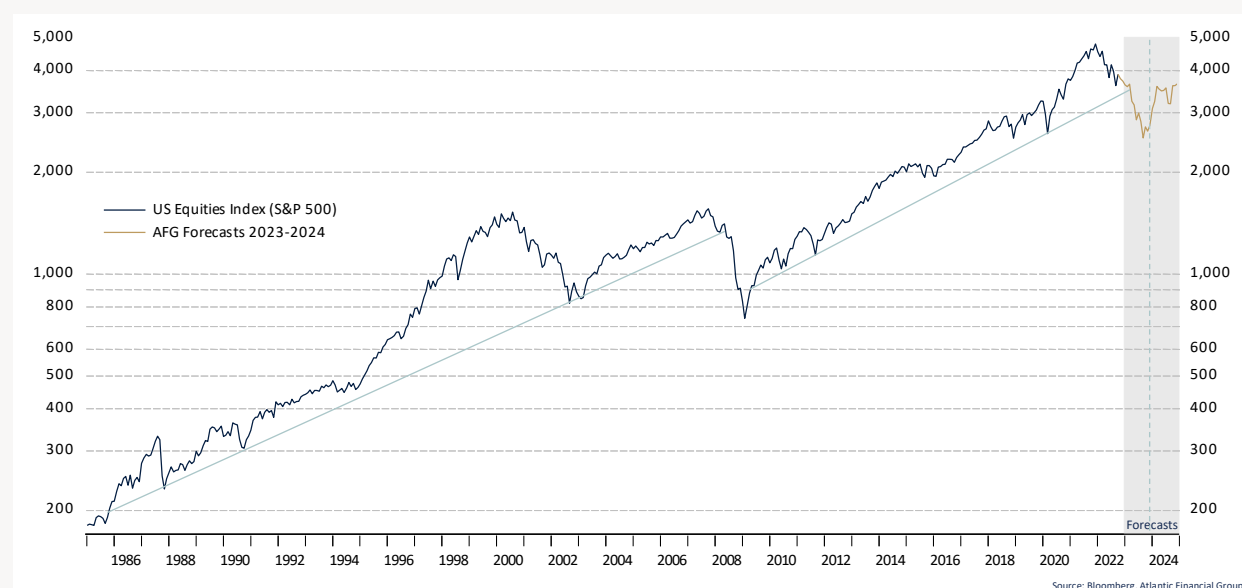
Weekly Investment Focus

21 November 2022

"OUTLOOK 2023: THE CAPITULATION PHASE"

- ◆ The recession has just started, and the equity bear market is not over
- ◆ Central banks risk causing a debt crisis by hiking rates
- ◆ In order to ensure financial stability, they will have to "pivot" suddenly
- ◆ Waiting for the trough of the cycle, investors will enjoy defensive assets

CHART OF THE WEEK: "The main objective will be to avoid bull traps"



FINANCIAL MARKET ANALYSIS

The time has come to draw up the macroeconomic and financial scenario for 2023 and to outline the contours for 2024. While 2020 was the year of the Covid, 2021 the year of exuberance, 2022 will be remembered by investors as the year of the double bear market. The stock and bond markets recorded significant and simultaneous losses. Such an event had not occurred since 1969. In Europe, balanced discretionary portfolios managed by wealth management services, recorded returns of -12% on average (see Fig. 2).



To get a glimpse of what is in store for next year, we continue to rely on proprietary econometric models. Their previous estimates, while imperfect, proved to be relatively correct (see articles published on [29/11/2021](#) and [01/02/2021](#)). The main advantage of this quantitative approach is that it removes all subjectivity. It avoids behavioural bias. **Compared to our previous year's forecast, three things have made the situation worse: soaring inflation, the war in Ukraine and China's zero-covid strategy.** The first two will continue to have an impact on financial markets next year.

Fig. 2 – Balanced Portfolio Performance Index

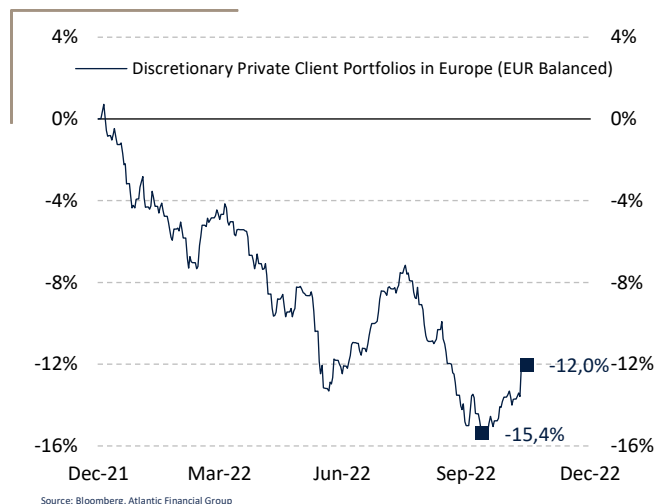
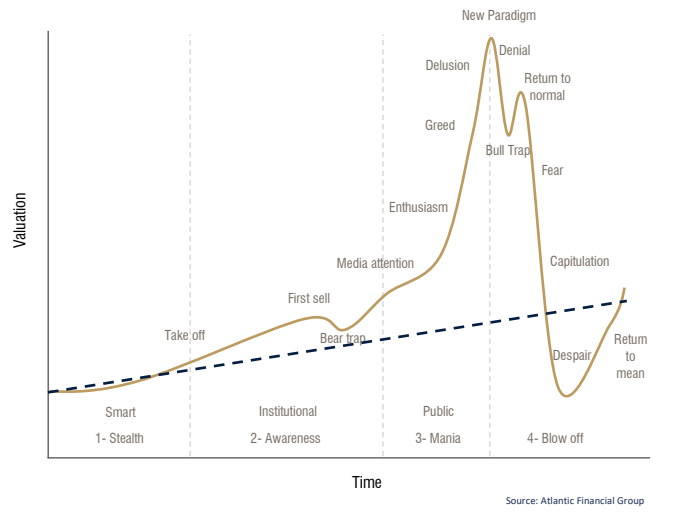


Fig. 3 – Emotional stages of an investment cycle



Let's take the suspense out of this article: 2023 should be the year of bull traps and the capitulation of equity investors. In military terms, capitulation is an agreement between warring nations whereby the defeated country surrenders, ceases all resistance, and submits to the goodwill of the victor. Less commonly known, the word comes from the Latin *capitulum* meaning chapter, as capitulations treaties usually consist of many chapters. By analogy, in finance, the capitulation phase requires several prior sequences (see Fig. 3). The last one occurs when investors massively and precipitously leave the market, selling their assets at any price, even in case of capital losses, to take refuge in other investments. This is also known as panic selling. In most cases, the complete sell-off corresponds to the low point of the market.

In 2023, investors will have to face several challenges: avoiding false starts, keeping their backs to the wall during panic phases, but also identifying the beginning of the next bull market. For the latter, at least one of these three signals must change from red to green:

- A rebound in leading economic indicators
- A very accommodative monetary policy
- An investors' capitulation

Let us look at the scenario in more detail. On the economic front, the recession is just beginning, whether in the US, Europe, Japan or most emerging countries (see Fig 4). Companies have already stopped



their investment spending and job creation is gradually giving way to waves of layoffs. In the end, only China seems to be able to pull through by easing its lockdown strategy against Covid and keeping its factories running at full capacity.

Inflation will fall significantly (see Fig. 5) but prices will remain high as the supply shock continues, second-round effects are amplified by rising service prices and increased wage claims, and price volatility is self-feeding the rise in inflation expectations. In this environment, households will see their purchasing power shrink further, curbing demand.

Fig. 4 - Growth forecasts

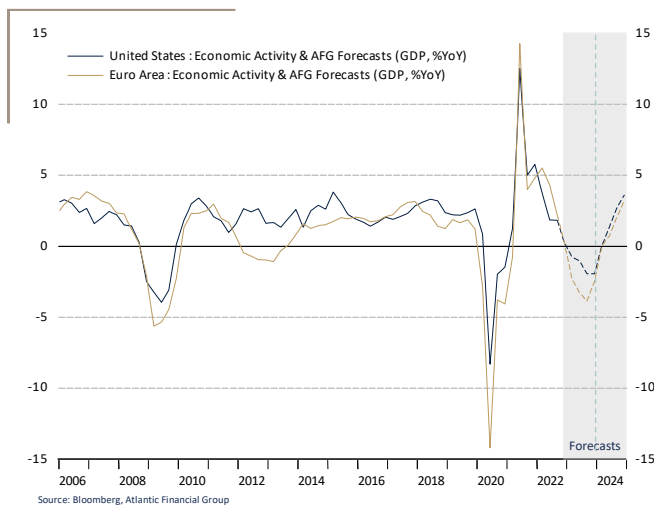
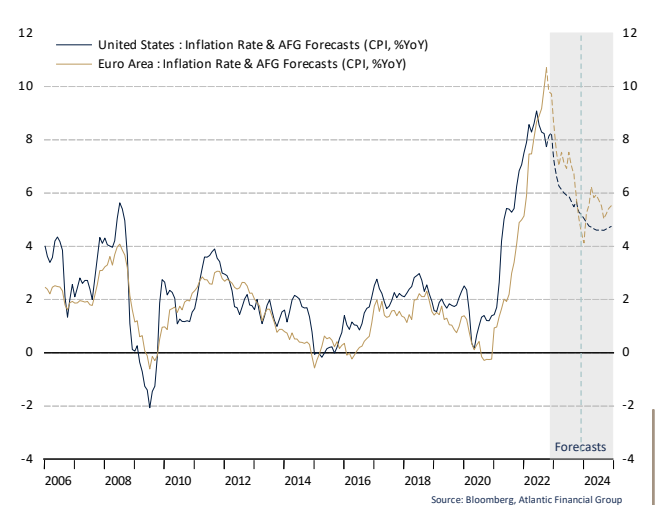


Fig. 5 - Inflation forecasts



This recessionary environment will be accentuated by the monetary policy mistake made in 2022. In trying to normalise their key rates, central banks seem to have forgotten that debt ratios are so high that the slightest rise in rates makes the debt burden unsustainable, not only for states but also for companies and households. **Although warranted, the fight against inflation is causing a debt crisis.** A solvency and liquidity shock will follow in 2023.

To prevent this crisis from seizing the whole system, central banks will have to "pivot" hastily: financial stability will take priority over the fight against inflation. In our scenario, the Fed and the ECB could choose to bring key rates close to zero, launch a new wave of money printing (*Quantitative Easing*) and inaugurate a Yield Curve Control. This reversal of monetary policy will mechanically drive bond yields to very low levels (see Fig. 6), far from the consensus estimates.

Some might conclude that the equity market will welcome this liquidity inflow. **Unfortunately, as in 2001 and 2008, the situation will be too recessionary for the stock markets to take off instantly.** A succession



of bull traps will drive the indices to new lows (see this week's chart) and gradually dissuade investors from taking risks: this will be capitulation.

Fig. 6 - Interest rate forecasts

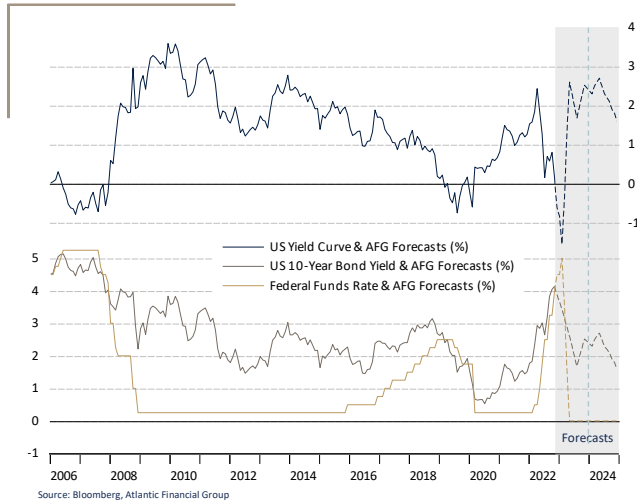
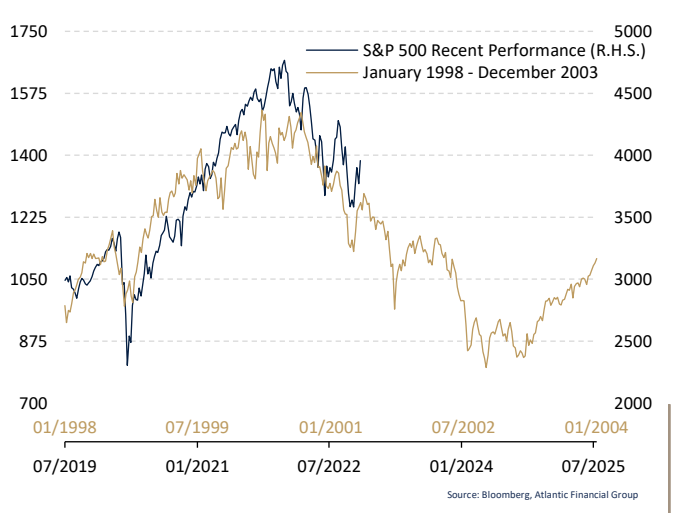


Fig. 7 - Equity market 2022-23 vs 2001-02



Anticipating when investors will capitulate is currently impossible. It will depend on how long it takes for central banks to realise their mistake. The sooner the better. If this bear market continues to mirror that of the dotcom bust (see Fig. 7) and the subprime crisis, then **the market trough could be reached in the last few months of 2023, paving the way for a sharp rebound in 2024**. If central banks react very quickly, then it could be sooner. If they delay too long, the crisis could drag on and become historic. We will develop this alternative scenario in a future analysis.

Is this scenario too bleak? It may be since it is the result of a succession of nested forecasts. The risk of error is never zero, but this scenario has several advantages: it is constructed in a quantitative manner without human bias, it is drawn up without any conflict of interest, and it is the logical and coherent continuation of the scenarios that have delivered good results over the last five years. **We will be sure to improve the outlook for 2023 if there is any good news, but in the meantime, savvy investors should take advantage of it:**

- Diversification will again become a "must" in portfolio construction.
- Sovereign and investment grade corporate bonds will benefit from the central bank "pivot" and the associated fall in yields.
- Increasing duration will allow to take advantage of the decline in inflation and furthermore of a potential Yield Curve Control.
- Defensive stocks, whether they are from the healthcare or consumer staples sectors, listed in Switzerland, or value stocks (see Fig. 8) will outperform, as they do in every bear market.
- Emerging market equities and bonds, especially Chinese ones, should make a comeback after several difficult years.



- The dollar will reduce its overvaluation in favour of currencies such as the euro and even more so the Swiss franc (see Fig. 9).
- Gold will appreciate, having suffered from positive cash returns and a strong dollar.
- Commodities, especially energy, will continue to benefit from past underinvestment, while industrial metals will have to wait for the cyclical rebound.
- Structured products with a capital guarantee, which made a comeback in 2022, will gradually give way to participation strategies.

Fig. 8 - Performance of Value vs Growth companies

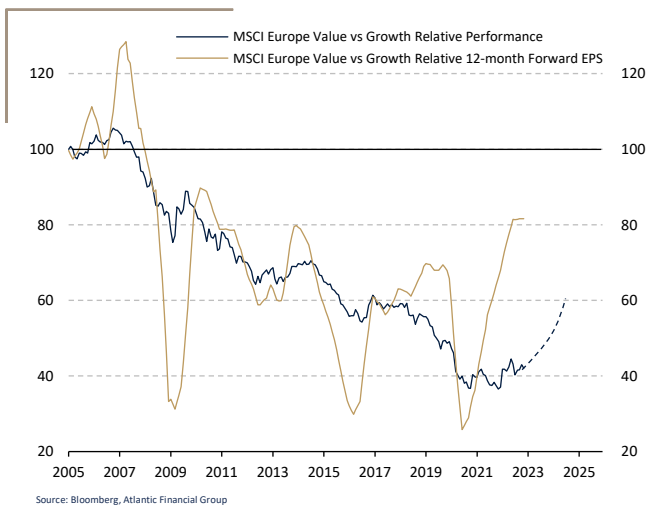
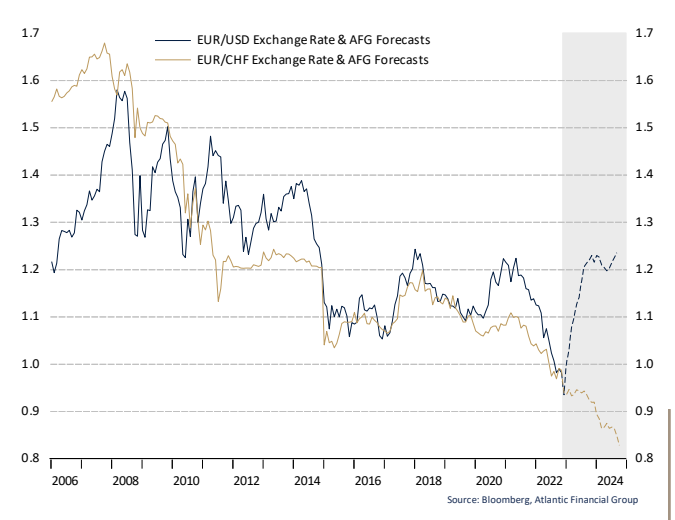


Fig. 9 - EUR/USD & EUR/CHF forecasts



Conclusion:

The year 2023 does not look any easier than 2022. Experienced investors will remember that recessions are usually more painful than initially anticipated by the consensus. This phenomenon is accentuated when central banks tighten credit standards, causing a real estate crisis or possibly a systemic crisis. The equity bear market is therefore likely to last for a few more quarters, until scalded investors finally capitulate. In the meantime, bonds, gold, and defensive equities will help improve portfolio performance.



RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2022 Year-to-Date (%)	2021 (%)	2020 (%)
Equities							
World (MSCI)	616.0	62.48	-0.4%	8.3%	-16.7%	19.0%	16.9%
USA (S&P 500)	3 965	58.58	-0.6%	6.8%	-15.6%	28.7%	18.4%
USA (Dow Jones)	33 746	66.70	0.1%	10.8%	-5.4%	20.9%	9.7%
USA (Nasdaq)	11 146	54.05	-1.5%	3.6%	-28.2%	22.2%	45.0%
Euro Area (DJ EuroStoxx)	421.6	72.47	0.8%	11.2%	-9.2%	23.5%	0.8%
UK (FTSE 100)	7 386	65.69	1.0%	6.7%	3.8%	18.4%	-11.4%
Switzerland (SMI)	11 045	61.58	-0.7%	4.4%	-11.8%	23.7%	4.3%
Japan (Nikkei)	27 945	55.36	-1.3%	2.7%	-1.1%	6.7%	18.3%
Emerging (MSCI)	943	63.50	0.8%	7.4%	-21.3%	-2.3%	18.8%
Brasil (IBOVESPA)	108 870	39.27	-3.0%	-5.9%	3.8%	-11.9%	2.9%
Russia (MOEX)	2 189	57.52	-0.5%	8.6%	-37.0%	21.9%	14.8%
India (SENSEX)	61 162	64.19	-0.2%	4.8%	7.8%	23.2%	17.2%
China (CSI)	3 769	52.92	0.3%	-0.9%	-21.4%	-3.5%	29.9%
Communication Serv. (MSCI World)	71.69	56.23	0.3%	2.0%	-34.2%	10.9%	24.2%
Consumer Discret. (MSCI World)	289.5	54.58	-1.7%	2.7%	-28.7%	9.2%	37.0%
Consumer Staples (MSCI World)	265.0	69.51	1.6%	8.2%	-7.1%	11.7%	8.8%
Energy (MSCI World)	248.8	57.79	-1.5%	10.7%	38.2%	37.5%	-27.7%
Financials (MSCI World)	132.6	65.19	-0.8%	9.6%	-8.1%	25.1%	-3.1%
Health Care (MSCI World)	336.6	64.63	0.7%	6.9%	-7.4%	18.0%	15.4%
Industrials (MSCI World)	285.2	68.54	-0.2%	12.0%	-12.4%	16.6%	11.8%
Info. Tech. (MSCI World)	417.1	60.39	-0.6%	10.2%	-26.6%	27.6%	46.2%
Materials (MSCI World)	311.7	65.47	-1.3%	12.3%	-11.3%	15.4%	21.6%
Real Estate (MSCI World)	173.7	60.73	-1.2%	8.0%	-28.9%	23.6%	-5.7%
Utilities (MSCI World)	147.9	60.85	1.1%	8.4%	-6.4%	11.1%	4.8%
Bonds (FTSE)							
USA (7-10 Yr)	3.80%	58.08	0.5%	1.4%	-14.8%	-2.4%	9.3%
Euro Area (7-10 Yr)	2.62%	59.57	1.6%	3.2%	-15.6%	-2.9%	4.5%
Germany (7-10 Yr)	2.02%	56.36	1.1%	1.8%	-18.8%	-2.7%	3.0%
UK (7-10 Yr)	3.24%	61.76	0.9%	5.5%	-14.8%	-4.9%	5.4%
Switzerland (7-10 Yr)	1.03%	62.39	0.9%	2.6%	-9.3%	-2.3%	0.4%
Japan (5-10 Yr)	0.25%	59.62	-0.1%	0.5%	-1.1%	0.0%	-0.1%
Emerging (5-10 Yr)	8.21%	67.94	0.5%	8.3%	-19.8%	-2.3%	5.2%
USA (IG Corp.)	5.50%	65.63	1.1%	5.3%	-16.7%	-1.0%	9.9%
Euro Area (IG Corp.)	4.01%	66.48	0.8%	3.5%	-12.8%	-1.0%	2.8%
Emerging (IG Corp.)	8.82%	69.00	0.9%	4.5%	-18.5%	-3.0%	8.1%
USA (HY Corp.)	8.82%	61.22	0.2%	3.1%	-11.6%	5.3%	7.1%
Euro Area (HY Corp.)	7.86%	72.00	-0.1%	4.8%	-11.0%	3.4%	2.3%
Emerging (HY Corp.)	11.74%	69.66	0.4%	7.9%	-16.0%	-3.2%	4.3%
World (Convertibles)	359.4	58.57	-0.5%	3.2%	-18.0%	2.4%	38.8%
USA (Convertibles)	481.1	55.39	0.3%	2.4%	-18.9%	3.1%	54.5%
Euro Area (Convertibles)	3 531	69.95	-0.1%	3.5%	-18.0%	-0.3%	6.1%
Switzerland (Convertibles)	173.4	68.92	0.5%	2.0%	-6.7%	-0.5%	0.5%
Japan (Convertibles)	198.6	50.71	0.1%	-0.4%	-1.1%	3.3%	2.8%
Hedge Funds (Crédit Suisse)							
Hedge Funds Indus.	732	64.42	n.a.	0.6%	0.7%	8.2%	6.4%
Distressed	928	54.59	n.a.	-0.7%	-4.0%	12.5%	3.8%
Event Driven	751	48.02	n.a.	0.9%	-7.6%	12.9%	7.0%
Fixed Income	383	55.87	n.a.	0.4%	-2.7%	5.2%	3.6%
Global Macro	1484	77.80	n.a.	-0.9%	23.1%	9.6%	6.5%
Long/Short	841	46.57	n.a.	1.7%	-9.3%	8.3%	7.9%
CTA's	423	79.83	n.a.	0.3%	23.7%	8.2%	1.9%
Market Neutral	285	54.82	n.a.	0.4%	-1.8%	6.2%	1.7%
Multi-Strategy	701	61.28	n.a.	1.4%	0.6%	7.0%	5.6%
Volatility							
VIX	23.12	36.45	2.7%	-24.2%	34.3%	-24.3%	65.1%
VSTOXX	20.88	30.51	0.5%	-27.8%	8.4%	-17.6%	67.5%
Commodities							
Commodities (CRB)	560.9	n.a.	-0.4%	0.9%	-3.0%	30.3%	10.5%
Gold (Troy Ounce)	1 743	59.17	-1.6%	5.1%	-4.7%	-3.6%	25.1%
Oil (WTI, Barrel)	80.08	37.43	-6.7%	-3.3%	4.0%	58.7%	-20.5%
Oil (Brent, Barrel)	86.92	36.85	-8.2%	-1.3%	13.7%	51.4%	-23.0%
Currencies (vs USD)							
USD (Dollar Index)	107.43	39.94	0.7%	-4.1%	12.3%	6.4%	-6.7%
EUR	1.0268	60.38	-0.6%	-4.1%	-9.7%	-7.5%	9.7%
JPY	140.76	61.93	-0.6%	4.9%	-18.2%	-10.2%	5.1%
GBP	1.1827	58.81	0.6%	4.6%	-12.6%	-1.0%	3.1%
AUD	0.6637	56.72	-1.0%	4.0%	-8.6%	-5.6%	9.6%
CAD	1.3419	53.33	-0.8%	1.6%	-5.8%	0.7%	2.1%
CHF	0.9558	61.70	-1.3%	4.4%	-4.5%	-3.0%	9.4%
CNY	7.1646	49.54	-1.3%	0.9%	-11.3%	2.7%	6.7%
MXN	19.511	55.91	-0.8%	2.2%	5.8%	-3.0%	-5.0%
EM (Emerging Index)	1 621.4	61.60	-0.4%	2.3%	-6.5%	0.9%	3.3%

Source: Bloomberg, Atlantic Financial Group

Total Return by asset class (Negative \ Positive Performance)



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