Crafter's Strategy Letter

October 2023 – CIO Office

National economies grip their crutches due to restrictive money policies

Our baseline scenario of a soft landing across the cycle of the U.S. economy, as well as signs of a cooling U.S. inflation, imply a likely end to the current Fed rate-hiking cycle in the near future. We expect high quality bonds to potentially provide attractive returns and risk diversification in this environment.

Source: Canva

Since the beginning of the year, the stock markets have recovered from the pronounced price setbacks in the 2022 crisis (MSCI World 10.1% YTD [1]). In Q3, some sanity returned to the previous high-flyers of the year such as the US technology sector or Japanese equities. During the last few trading days in September, however, some losses occurred. Thus, the past quarter ended with a negative balance (S&P500 -3.6%, SMI -2.8%, EuroStoxx50 -5.1% [2]).

Equities in the energy sector, which we consider to be extremely favourably valued, stood out positively and the sector is one of Q3's winners and pay attractive dividends. In addition, we still favour the health care and industrial sectors.

The Federal Reserve (Fed) has raised the key interest rate four times so far in 2023 by a total of 100 basis points, leading to a higher evaluation of equities. Overall, equities are, however, not as overpriced as they may first seem. Whilst the S&P 500 has a price-to-earnings (P/E) ratio of 19x based on earnings estimates for the next twelve months, if you remove the 7 largest companies from the index (Facebook, Apple, Nvidia, Google, Microsoft, Amazon, Tesla), the remaining 493 stocks trade at a more reasonable P/E of 17x. A median value we have often seen since 1995.

Macro: Bad news is good news

In the U.S. there was a certain insecurity amongst investors regarding how far the Federal Reserve might go with its interest rate hikes. This despite a consistently strong labour market and a decreasing inflation which remains drastically above the 2% inflation target. Thus, weaker economic figures were well received, as they fed the hope of a potential pause in hikes.

At the same time, leading economic indicators such as the purchasing managers' indices (PMIs) continue to paint a gloomy picture of the economic outlook. A paradox, which is not rare in

[1] YTD: Performance in USD 31.12.22 - 30.09.23
[2] Q3: Performance 30.06.23 - 30.09.23

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the stock market.

Equities	YTD 2023	Q3 2023
MSCI World AC (USD)	10.1%	-3.4%
S&P 500 (USD)	11.7%	-3.6%
Eurostoxx 50 (EUR)	10.0%	-5.1%
SMI (CHF)	2.2%	-2.8%
FTSE 100 (GBP)	2.1%	1.0%
Nikkei (JPY)	22.1%	-4.0%
MSCI Emerging(USD)	-0.4%	-3.7%
Bonds	**YTD 2023**	**Q3 2023**
Bloomberg Global Aggregate	-2.2%	-3.6%
US Treasury 10y	-3.8%	-3.7%
US Corporate	0.0%	-3.1%
Bund 10y	-3.2%	-3.8%
EU Corporate	2.5%	0.3%
Currencies	**YTD 2023**	**Q3 2023**
USD Index	2.6%	3.2%
EUR/USD	-1.2%	-3.1%
GBP/USD	1.0%	-4.0%
USD/CHF	-1.0%	2.2%
EUR/CHF	-2.2%	-1.0%
GBP/CHF	-0.2%	-1.8%
Other	**YTD 2023**	**Q3 2023**
Brent oil	10.9%	27.2%
WTI Crude	13.1%	28.5%
GOLD SPOT $/OZ	1.3%	-3.7%
Silver Spot $/Oz	-7.4%	-2.6%
BBG Commodities Index	-7.1%	3.3%
US REIT	-2.0%	-7.0%

Communist economic policy: Broken promises on the horizon?

China's Communist Party faces a complex array of growth challenges. In July, we witnessed a continued decline in industrial production, fixed investments, and retail sales. The consumer spending figures are restrained.

Much has changed since our update of our Investment Committee's assumptions in November 2022. Back then, we decided to not hold any Chinese direct investments due to the increasing geopolitical tensions between the U.S. and China. However, we could see some opportunities arising from China's new anticyclical policies.

Most western market observers seem to take almost no improvements into consideration when painting their macro picture of China. Hence, the potential for positive surprises seems attractive. Nevertheless, we are not buying directly in China. We rather predict a positive momentum for global stock markets and the general Asian sphere, should the Red Dragon roar back to life.

In addition to sluggish economic growth, there are concerns over China's deflation, its heavily indebted developers, and the difficulties of its shadow banks and municipal governments to manage their debts. China's economic struggles are an inevitable adjustment after years of overinvestment and accumulation of debt. Beijing recognises the unsustainability of this growth model and is focused on reducing non-productive investments.

The preoccupation with de-risking and preparing for possible conflicts with the West leads policymakers to under-stimulating the economy. The central government is reluctant to rescue debt-laden developers and local governments, wary of the associated moral hazard.

Without forceful policy support, a further decline in growth seems certain in the coming quarters. Given the Chinese government's extensive control over the financial system, China's economic crisis is unlikely to unfold in the same conventional, textbook manner as it has in Western economies.

With the Communist Party committed to huge promises of prosperity and global leadership to its members and now taking cautious steps to support growth, the yuan could depreciate further and strengthen Chinese exports. A rapid depreciation of the yuan and other emerging market currencies could also prompt central banks to intervene.

Short- to medium-term Bonds, particularly US Dollar and Sterling denominated investments, have recently become attractive. This is based on last year's dramatic repricing for bond investments, which sent U.S. bond yields, amongst others, to their highest levels in a decade.
Equitywise, we consider the "higher for longer" interest rate mode and the economic situation to be largely priced in. Consequently, following Q3's setbacks, a potential rally is in the starting blocks. We are positioned accordingly.