Crafter's Strategy Letter

July 2023 – Valeria Capital AG

A foot in both camps

The dark clouds on the horizon have yet to pass, and the predicted economic downturn is evident. Should investors tighten their seat belts even further? We think not as, despite the uncertainties, we look to the future with cautious optimism.

Source: Canva

Strong divergences in sector performance

Post the March banking crisis, investor confidence gradually returned to the markets during Q2. At the same time, Credit Suisse became history; losing its independence and stock market listing in June and is now fully integrated into UBS. This event brought no glory to the Swiss financial sector. One can only hope that the Swiss virtues will be retrieved from the storage room they have been forgotten in and the conduct of our banks restored to former heights.

Only briefly during banking crisis were June's potential interest rate cuts a topic among investors. At present, markets are predicting further interest rate hikes during the summer and the first interest rate cuts to commence in Q4. During the past quarter, discussions regarding the US debt ceiling further ramped up. A last-minute compromise was only reached by imposing spending restrictions on the government. Inflation rates declined in numerous regions; however, at a more moderate pace than expected, leaving the market somewhat uncertain about the future interest rate outlook. Economic data continues to indicate an economic downturn. Investment activities have already weakened, while consumer spending still remains surprisingly robust.

Global stock markets showed positive performances in Q2. The S&P500 officially reached bull market status, meaning it rose by more than 20% since its low point in October 2022. Within the equity markets, the technology sector experienced particularly strong growth. The sudden above-average performance has been driven by investors' interest in artificial intelligence. Thus, the S&P500 has achieved an overall YTD[1] return of 15.9%; however, excluding the seven major technology stocks, its performance was 'only' 5%. In contrast, energy and commodity stocks performed rather poorly. China also fell significantly short of the expectations of many forecasters with its performance of -9.7% (MSCI China in USD).

[1] YTD (Year to date): Performance 31.12.22-30.06.23

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Equities	YTD 2023	Q2 2023
MSCI World AC (USD)	13.9%	6.2%
S&P 500 (USD)	15.9%	8.3%
Eurostoxx 50 (EUR)	16.0%	1.9%
SMI (CHF)	5.1%	1.6%
FTSE 100 (GBP)	1.1%	-1.3%
Nikkei (JPY)	27.2%	18.4%
Nasdaq Composite	31.7%	12.8%
MSCI Emerging(USD)	3.5%	-0.1%
MSCI China (USD)	-5.5%	-9.7%
Bonds	**YTD 2023**	**Q2 2023**
Bloomberg Global Aggregate	1.4%	-1.5%
US Treasury 10y	0.0%	-2.3%
US Corporate	3.2%	-0.3%
Bund 10y	0.6%	-1.5%
EU Corporate	2.2%	0.4%
Currencies	**YTD 2023**	**Q2 2023**
USD Index	-0.6%	0.4%
EUR/USD	1.9%	0.6%
GBP/USD	5.1%	3.0%
USD/CHF	-3.1%	-2.2%
EUR/CHF	-1.3%	-1.5%
JPY/USD	-9.1%	-7.9%
GBP/CHF	1.6%	0.7%
Other	**YTD 2023**	**Q2 2023**
Brent oil	-12.8%	-6.1%
WTI Crude	-12.0%	-6.6%
GOLD SPOT $/OZ	5.2%	-2.5%
Silver Spot $/Oz	-4.9%	-5.5%
Iron ore	3.3%	-7.6%
BBG Commodities Index	-10.0%	-3.8%

Inflation in retreat, but…

Overall declining inflation is currently mainly driven by high shelter costs. Whilst we anticipate a continuing reduction in inflation, we also believe that investors must prepare for heightened underlying inflation. The reason behind this is several persisting price driving factors, such as nearshoring[2] and labour shortages. Thus, central banks are likely to pause their interest rate hikes and closely monitor economic developments. Currently, we see the risk of further interest rate hikes as greater than the possibility of interest rate cuts in 2023. After all, it is a balancing act: In the worst-case scenario, central banks could either stifle the economy with their excessive interest rate tightening or let inflation spiral out of control. Due to the delayed effect of interest rate hikes and the tightening of credit conditions, we expect further economic slowdown. Consequently, recession risks are increasing in major economies, as central banks could overstrain their restrictive monetary policies.

Furthermore, liquidity is being withdrawn from the financial system due to central banks' shrinking balance sheets. The economic slowdown is expected to extend into 2024, as indicated by the decreasing levels of investment activity and industrial output. Consumer confidence, consumption, and the labour market will also be negatively impacted. However, the service sector and labour markets have shown remarkable resilience, which is a positive sign.

Depending on the extent of the economic downturn, the environment for corporate earnings and margins will become more challenging. However, we can expect an increase in positive impulses as a consequence of China's reopening after their lockdown, even with the market currently only registering a surprisingly small influence.

The Sword of Damocles of higher interest rates: Not 'one size fits all'

Declining yet persistent inflation supports the notion of stable interest rates. We believe that interest rates will remain at their current levels, and we view the environment for high-quality bonds as increasingly favourable.

Direct pressure from rising interest rates on stock markets has already diminished. However, the effects of declining liquidity levels (including credit standards and central banks' balance sheets) are expected to intensify. Despite the economic slowdown, we believe that certain sectors are more resilient to the downturn. Alongside defensive stocks in the healthcare

[2] Outsourcing of services to nearby areas

sector, stocks benefiting from positive trends in the technology field (such as artificial intelligence) are valid candidates. Additionally, companies that can still profit from the delayed effects of China's reopening are being considered. Stocks that capitalise on the pent-up demand for services also display favourable resilience.

Challenges lie ahead for corporate earnings as profit margins are expected to generally decline. However, we simultaneously anticipate that specific companies will experience increased demand again as their customers have reduced their inventory levels in previous quarters, leading to a normalisation of the purchasing cycle.

This year's stock performance has been one-sided and focused on artificial intelligence as well as certain small and mid-cap stocks. Nevertheless, high-quality "laggards" are still present in the market, which we continue to find interesting. This includes stocks within the consumption, healthcare and energy sectors. Since the beginning of June, some of those underperforming stocks have already caught-up to the overall market again. We are confident that our barbell equity positioning, comprising of defensive, high quality and attractively valued stocks as well as well-performing technology and growth stocks, will bear fruits.

In the current quarter, it is key to seize the momentum while keeping a watchful eye on the sky and its dark storm clouds.