REYL OVERSEAS

STRATEGY OUTLOOK

September 2022

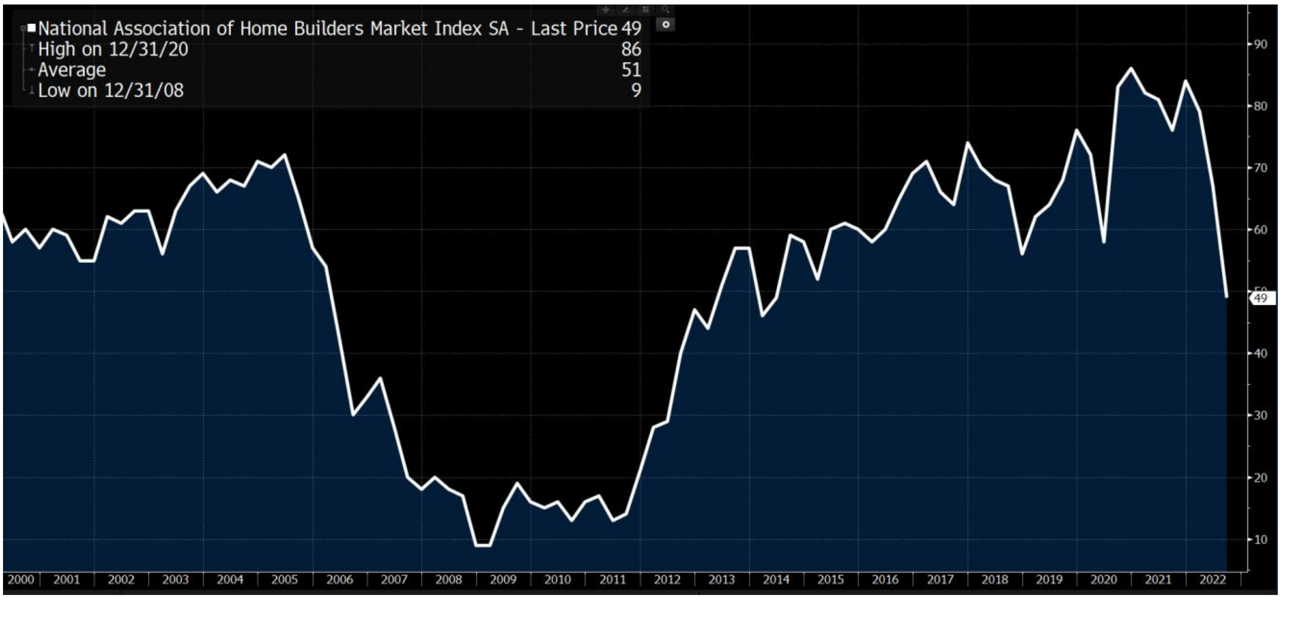
August reversed the positivity of the two proceeding summer months as Fed Chairman Powell's speech in Jackson Hole shook markets. **The message from Powell was clear**, the Fed will not be stopping interest rate hikes anytime soon.

However, these comments come in the face of economic data that continues to disappoint from the consumer or business to housing. **In Europe the focus remains on an energy crisis**, its impact and a currency that keeps getting cheaper.

Stock markets were negative for the month. The NASDAQ finished down -4.6%, Eurostoxx -6.4%, FTSE -1.8% and the SMI down -2.6%. These were heavily influenced by the strength of the dollar which saw the Japanese Yen lose 4%, the Euro lose 1.6% and even the Swiss Franc -2.5%. Commodities fell 0.15% with Gold losing 3% and Oil falling 12%, again partially due to the USD strength, with bonds also weakening up 50bps in yield on the 10yr US Treasury.

Chairman Powell, at the annual Federal Reserve Jamboree in Jackson Hole, told markets that more rate hikes are coming. To ensure the market was not snoozing he even quoted former Chair Paul Volcker and **in the space of an 8-minute speech knocked nearly 4% off the S&P** and other indices. Volcker was chair from 1979-1987. He took interest rates to 19% in June 1981 as inflation hit 14.6% in April 1980. This induced two recessions, unemployment hit 10.8% and the S&P fell 33%.

Adding to the worry is **Quantitative Tightening** (QT) i.e., the selling/maturity of assets on the Fed's balance sheet which **begins next month** at a rate of $94bn a month. However, we also know that exactly a year ago Powell spoke about inflation being "transitory" and that there was no reason to raise rates. Today after having raised rates by the fastest pace in three decades, we are starting to see ominous signs in the housing market and consumer behaviour. We will have to wait to see if Powell is simply "talking tough" for the benefit of his Democratic party-political masters into the Mid terms, or not. **The chances of a Fed pivot/pause sometime this year haven't dramatically changed in our view and we remain concerned on growth.**



Housing is slowing down rapidly as the graph highlights and although this will be nowhere near as bad as 2008/2009 housing is very important to GDP.

The Democrat-backed spending bill, the so called "Inflation Reduction Act" was passed by the Senate and includes student loan forgiveness. This was probably the last gasped attempt to win back a few voters ahead of November's Mid-terms. Spending money to "reduce inflation" is however an oxymoron.

The Fed seem willing to sacrifice growth to slay inflation. They have been behind the curve on policy. Aren't they just fighting the last battle? The Midterms are a political hot potato so we should expect blinding allegiance to that event until the growth side of the economy really disintegrates. A recent survey from PwC polled 700 US executives and board members across a range of industries. Half of respondents said they're reducing headcount or plan to and 52% have implemented a hiring freeze. The Fed will push till they break something then over stimulate to correct their mistake.

The Eurozone is in trouble. It previously had one engine of growth in German manufacturing which was then totally reliant on cheap Russian energy. What's left are massive trade deficits, glaring signs of a recession, the threat of energy rationing and a dramatically reduced competitive advantage. A ten-year low EURO currency is a small positive albeit in the face of electricity prices up over 500% on a year ago and +1300% on a 5 year view its a tiny positive.

As the huge increase in electricity prices on a 5-year view highlights the blame cannot simply be due to the Russian/Ukraine conflict. The single focus on renewables by Government and complete lack of investment in a plan B is where blame should lie.

German natural gas storage levels are now nearly full again going into Autumn, but energy bills are being mailed out. We are however starting to see **the decimation of small to medium sized businesses and consumers** who simply cannot pay 5x their normal energy bill.

These lessons aren't being learnt, however. Australia has announced its plans to be net zero in emissions by 2050. The country plans to be 100% weather dependent in its focus on solar and wind. BHP, the miner has already stopped future coal capex in Queensland after politicians slapped a tax on production. We are incredibly bullish on battery technology in the years to come but would caution about always having diversified sources of energy. We continue to believe Nuclear offers a solution and the advances, e.g., made by Rolls Royce will change Nuclear's role going forward.

For the ECB hiking rates in this environment makes no difference. **The ECB cannot control energy or food prices**. They can control demand for a good but never the supply. These conditions set up the potential for further political change at election time.

Interestingly last week the Hague sought a "temporary" exemption from EU sanctions against Russia as it "struggles to find a replacement for its contract with Russian gas supplier Gazprom in time ". Additionally German parliament vice president Kubicki has been calling for Nord Stream 2, the gas pipeline to be reopened so "people do not have to freeze in winter".

Japan, South Korea and Taiwan its emerged bought $5.5bn of Russian fuel in the 5 months post the invasion. **Could we see a complete about face in demand for Russian energy by Europe?** It would certainly be a significant positive to European assets and its currency. A tough winter could make that a possibility, but other options are also being explored.

French President Macron travelled to **Algeria** in August, ultimately, begging for energy. There are already pipelines between Algeria and Italy/Spain, but the vast reserves remain largely untapped, and this cant simply be turned on tomorrow. Additionally, there are also reports of the French Foreign Legion in Syria, again securing energy supplies.

Another source of additional energy is in the Eastern Mediterranean with estimates that these could provide 20% of Europe's needs in the future. The ongoing dispute between **Cyprus and Turkey** is an issue yet the Israelis own the development licenses. Not surprisingly Turkey is restoring diplomatic ties with Israel.

In **Italy** Mr Berlusconi has announced he is running again for the Senate at the ripe old age of 86 which should keep Italian politics interesting, not that it isn't with Italy back at the polls on 25 September following the latest collapse of its government. Moody's, the rating agency, moved the outlook on Italian government bonds (BTPs) to negative with now no more downside room to remain Investment Grade. Its therefore not surprising the hedge fund positioning is heavily underweight BTPs with the only buyer being the ECB. Italy is a significant debt market and its spill over into the rest of the periphery could spell issues last seen in 2012.

The **Dutch** government is capping the number of flights from Amsterdam at 440,000, a 12% cut to pre-pandemic levels. This new policy, set to take effect at the end of next year, is the world's first to limit flights for environmental reasons. It follows both Holland and Canada cutting agriculture output for environmental reasons. We suspect the BRICS won't be following suit and expect continued relative strategic underperformance from enforced feel-good sanctions imposed by Western governments.

Away from the gloom and the Pound, Swedish Krona and Euro are all testing 10 year lows it's not surprising that European earnings are seeing positive revisions. For a company like LVMH, the luxury brand retailer with a reporting currency in euro, 42% of revenues come from Asia, 26% from the Americas and only 20% from EMEA. So, within the European gloom some assets are benefiting but the energy issue isn't going away. Utility giant Uniper, for example, is losing $100m a day and has requested $4bn in loans from state owned lender KfW.

The outlook continues to point towards holding a defensive stance in markets. Its debatable how much influence central banks raising rates can have on energy or food inflation. Growth is going to continue to struggle, and we expect inflation to slow but this is a relatively long process. Portfolios remain small underweight to stocks with an overweight to Government bonds and unchanged positioning to alternatives, gold and cash.

Zurich portfolio management team.

CONTACTS

SWITZERLAND

REYL Overseas Ltd
Talstrasse 65
8001 Zurich
T +41 58 717 94 00
F +41 58 717 93 01
contact@reyl-ovs.com
www.reyl-ovs.com

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