MFM
MIRANTE FUND MANAGEMENT

Market Overview

JULY 2022

We believe in active management based on a structured investment process to ensure optimal diversification in terms of asset classes, types of financial instruments and geographic sectors. Risk management is an investment tool fully integrated into the portfolio construction process.

The benefits of this approach are numerous: the reduction of risk against significant market declines, as well as the potential to create increased value over the long term.

Frank Crittin, Chief Investment Officer

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EVENT OF THE MONTH AND IMPACT ON FINANCIAL MARKETS

Inflation in most developed countries, except China, continued to rise faster than expected, particularly in the United States. To make matters worse, there are many signals that consumer expectations for medium-term inflation have risen sharply. This is the greatest fear of central bankers, whose primary mission is to control inflation. Therefore, investors logically anticipated a strong reaction from central bankers to combat this price rise. This was confirmed by the actions of most central banks raising their rates aggressively. The biggest surprise came from Switzerland, which raised its rates before the European Central Bank. As a consequence, bond markets were under intense pressure again, with the tectonic rise in global interest rates pushing bond prices into deep negative territory.

In the middle of the month, fears of a recession, induced by the rise in interest rates and inflation, took over the level of investors' fears. These fears weighed significantly on all risky assets, including stocks, high-yield bonds and cryptocurrencies, and eventually, pushed interest rates down. In this very hostile environment, it should be noted that commodities have decoupled from inflation. While the latter are among the factors that contributed to the explosion of inflation, their prices have suffered from fears of a recession and its impact on energy demand, despite the Ukrainian crisis and China's good performance. China is, in fact, the only region that posted a positive performance in this nightmarish month for all asset classes. It benefited from the reopening of its economy following the strict confinements imposed by the government to combat the pandemic and the stimuli initiated to support the Chinese economy. Xi Jinping confirmed that he still aims for 5.5% growth in his economy this year and promised to reduce the pressure on Chinese technology companies.

At the bond level, all classes ended the month in negative territory. The combination of fears of a recession and quantitative tightening in the United States pushed long rates down, inverting the yield curve. High yield bonds came under pressure. Credit spreads [the compensation investors demand for holding riskier bonds than government bonds], have shown tangible signs of stress causing this asset class to fall sharply.

At the stock level, all sectors posted negative performances. The least bad were sectors considered defensive during an economic downturn, such as consumer staples, healthcare or utilities. On the other side of the spectrum, the energy and materials sectors suffered the consequences of the fall in the price of raw materials. Regionally, China is the only region in positive territory as described above. On the other hand, Europe and the United States, the two regions most affected by inflation, posted extremely harmful performances.

The real estate sector benefited from its defensive nature to inflation, posting less damaging performances than most equity sectors.

Alternatives strategies performed decently in this environment, especially strategies showing little correlation with the beta of major asset classes.

MACRO PERSPECTIVE

Three of the four major economic drivers in financial markets are currently in an unfavorable spiral: global growth, interest rates and inflation. The only driver that has not yet been hit is corporate profits. So let us take a closer look at these factors.

(1) Global growth is slowing under the impulse of central bankers. They are aggressively slowing down their economies to reduce inflation, especially that it does not settle at a too high level. Ideally, they would like to slow the economy enough to reduce inflation but not too much to avoid inducing a severe recession. Predicting whether they will succeed is very difficult; even central bankers cannotcalibrate their intervention very precisely.

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NUMBER OF THE MONTH:

13% **is the share of the manufacturing industry in the GDP of the OECD club (composed mainly of rich countries): a historically low level.**

(2) Inflation has run following the shock of demand generated by the euphoria of emerging from the pandemic and by the supply shock (especially at the raw materials level) generated by the invasion of Ukraine. However, predicting the trajectory of inflation is highly tricky since no macroeconomic model manages to explain inflation movements accurately. The surprises will therefore continue on the level of inflation. However, we could be close to a peak in the level of inflation because it seems unlikely that wage and real estate inflation could accelerate significantly faster than the surge in commodity prices over the past six months. On the contrary, it could fall faster than the markets expect.

(3) Interest rates will follow the path of inflation. If inflation does not rise faster than expected, future rate hikes are likely priced at current bond prices. The bond market integrates these prices very quickly.

The surprises associated with the rate are, therefore: (i) on the upside inflation and (ii) on the downside, a sharp slowdown in the economy.

(4) Company prices are for now, and surprisingly, remaining stable. Indeed, the margins of the latter were only slightly impacted by the spectacular rise in the price of raw materials. The same goes for analysts' estimates, which for the moment, have not significantly lowered their estimate for the next 12 months. The next earnings season should tell us more and, no doubt, the slowdown in the global economy will be transferred to profits.

While it is difficult to predict the trajectory of the major market drivers, volatility is easier to anticipate. Indeed, it should remain high in the coming months due to uncertainties related to the outlook for inflation, fears of recession and the persistence of political tensions.

POSITIONING OF OUR INVESTMENT STRATEGIES

Regarding positioning, we avoid positioning ourselves in a single scenario because the probability of making a correct prediction in the current environment is negligible. On the contrary, we try to build strategies that can navigate these various scenarios with as much resilience as possible. At the allocation level, our indicators point out that allocating some risk to equities compared to bonds is appropriate. This is despite the rise in interest rates and, therefore, the expected bond returns. However, this increase has been offset by the quick reset in the equities valuation and all risky assets. Regarding strategy, we favor a systematic approach to rebalance our portfolios based on data and avoid being influenced by our emotional biases.

At the bond level, we are maintaining a cautious approach. We are taking advantage of the rise in interest rates to invest in government bonds, considered defensive, providing attractive returns. If the economy slows down significantly, it is likely that the rise in interest rates will slow down and will therefore allow defensive bonds to regain their stabilizing role by decoupling from equities. While rising interest rates and slowing economic growth will likely continue to weigh on high yield bond prices in the near term, long-term investments provide attractive values.

At the stock level, valuations have continued to fall and are close to traditional historical values. In the short term, valuations do not influence performance. However, they increase consistently expected return in the longer term (above five years). Tactically, we continue to add exposure to more defensive sectors, which should perform better in the event of a sharp economic downturn. The healthcare sector, in particular, combines resilient revenue growth with less exposure to economic fluctuations.

When volatility is high, financial stability risks are also higher; therefore, good management of the strategies' liquidity is essential. Indeed, it makes it possible to manage flows better and to seize longer-term opportunities that arise during crises.

We prefer active management that favors long-term strategic diversification over marked tactical bets. Robust portfolio construction remains central to cushioning expected swings in risk appetite across asset classes. This approach enables us to optimize the risk-return profile of all the strategies to better withstand the many possible macroeconomic scenarios.

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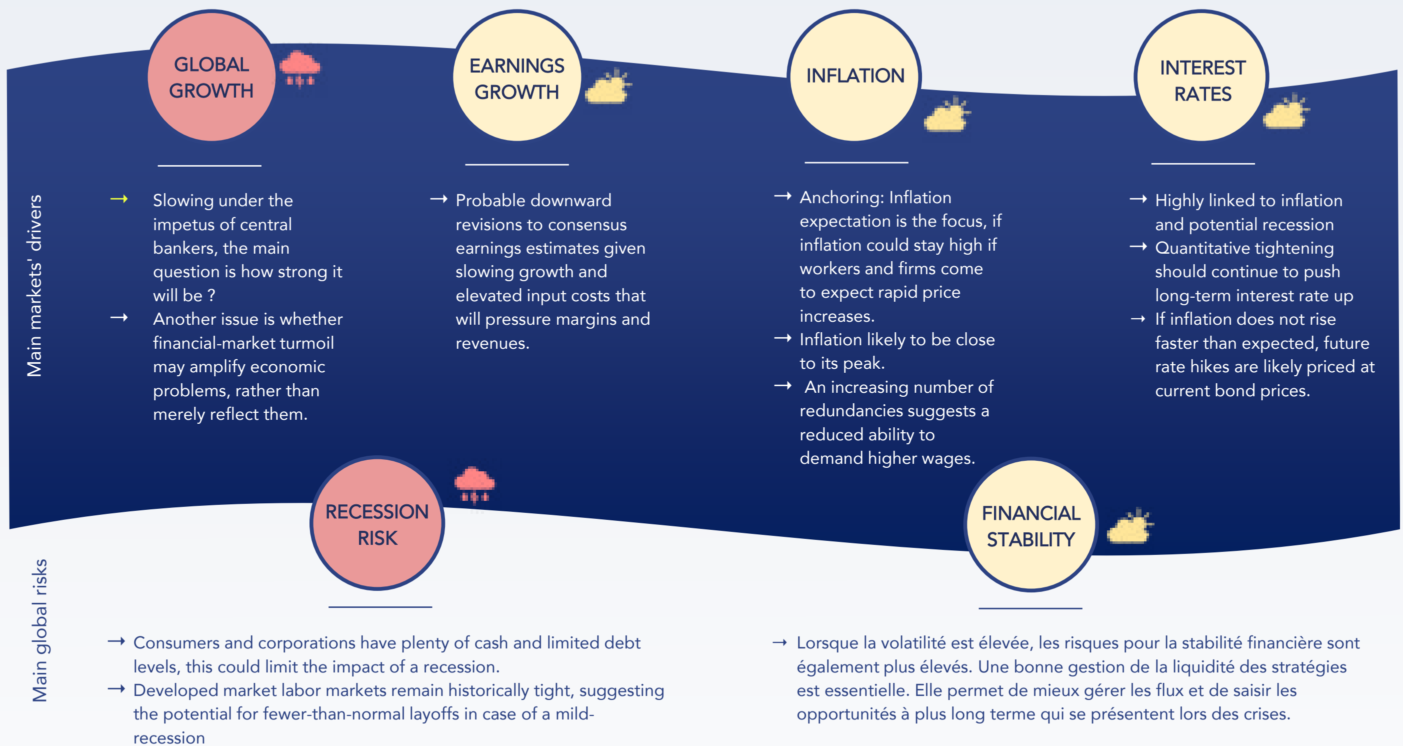
MAIN DRIVERS



→ Consumers and corporations have plenty of cash and limited debt levels, this could limit the impact of a recession.
→ Developed market labor markets remain historically tight, suggesting the potential for fewer-than-normal layoffs in case of a mild-recession

→ Lorsque la volatilité est élevée, les risques pour la stabilité financière sont également plus élevés. Une bonne gestion de la liquidité des stratégies est essentielle. Elle permet de mieux gérer les flux et de saisir les opportunités à plus long terme qui se présentent lors des crises.

SOURCE: MFM, July 2022

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MONTHLY PERFORMANCE, 30 JUNE

Equities Market (Local currency)	
China	6.63
Japan	-2.73
Asia (ex-Japan)	-2.99
Emerging Markets	-4.56
United Kingdom	-5.17
Switzerland	-7.17
World (all countries)	-7.77
United States	-8.32
Europe	-9.95

Equities Sector (Local currency)	
Consumer Staples	-2.36
Health Care	-2.50
Utilities	-6.05
Real Estate	-6.76
Telecommunication Services	-6.93
Industrials	-7.03
Consumer Discretionary	-9.09
Financials	-9.17
Information Technologies	-9.51
Materials	-14.01
Energy	-14.04

Fixed-Income (USD Hedged)	
Global Aggregate 1-3 Year	-0.46
Global Treasury	-1.12
Global Aggregate 5-7 Year	-1.28
US Treasury Long Duration	-1.47
Global Aggregate	-1.52
Swiss Bond Index AAA-BBB (CHF)	-1.88
Global Inflation-Linked Bonds	-2.08
Global Corporate Credit	-2.74
Global Aggregate Long Duration	-3.03
Emerging Market Hard Currency Aggregate	-4.87
Global Convertibles	-4.95
Global High-Yield	-6.99

Others (USD)	
Hedge Funds	-1.51
Commo Industrials (CBR)	-6.74
Commo Global (ThomsonReuters)	-10.88

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