Lotos Asset Management AG

Quarterly Investment Strategy

Lotos
Asset Management

January 2023

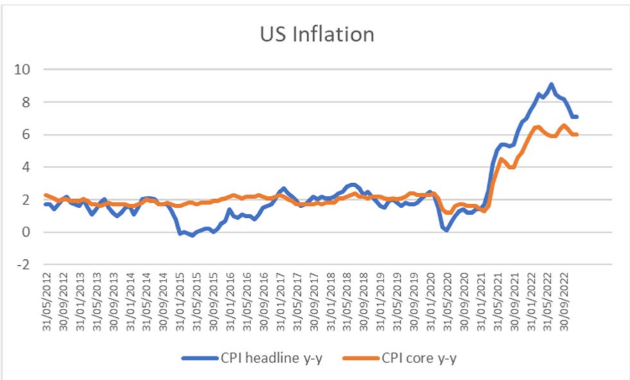
Can the Positive Momentum of 4Q be maintained?

2022 will enter economic history books as the "annus horribilis". Inflation and ensuing problems wiped out 16% from Global Stocks. Global Aggregate Bonds lost 11% and World Government Bonds even 22%, the biggest decline since at least 1990 as central bank raced to hike interest rates. There were really no places to hide.

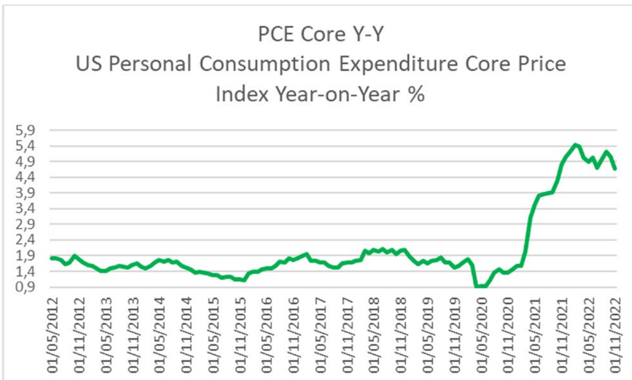
While many problems will not disappear easily, there are several important factors that show positive trends. To hope for a "annus mirabilis" might be too optimistic but numerous gloomy outlooks seem already at least partially reflected in markets. Out of experience we all know that the world tends to surprise us, so why not on the positive side for once.

In this Quarterly we like to focus on the key themes and our interpretation for what it means for financial markets.

A) Inflation

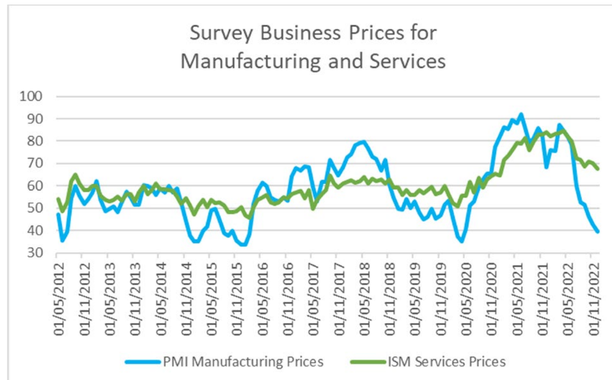


Source: US Bureau of Labor Statistics



Source: US Bureau of Economic Analysis

Source: US Bureau of Labor Statistics



Source: Institute for Supply Management

In the US, inflation gauges show a downtrend, which manifests itself very strongly in the manufacturing sectors. This confirms management comments about sequential improvement of the delivery chain situation. Companies observed improvements in terms of both lead times and delivery reliability, which means that they have started normalizing their inventories.

Labor costs slowly start to decrease after wild Corona-induced swings. The labor market seems relatively solid. Many sectors suffered from labor shortages. Managements may therefore be hesitant to lay-off employees, particularly if they have specialist knowledge or are difficult to find again in an eventual recovery. As labor costs are by far the biggest expense for many businesses especially in the service sector, the downtrend in prices in the Services Business Leading Indicators are less pronounced.

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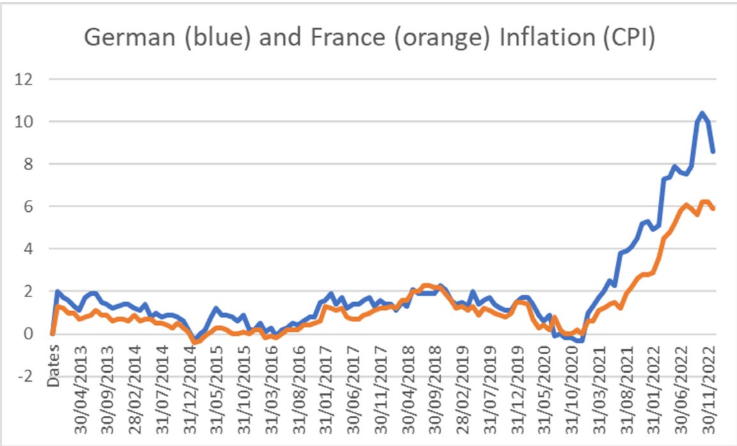
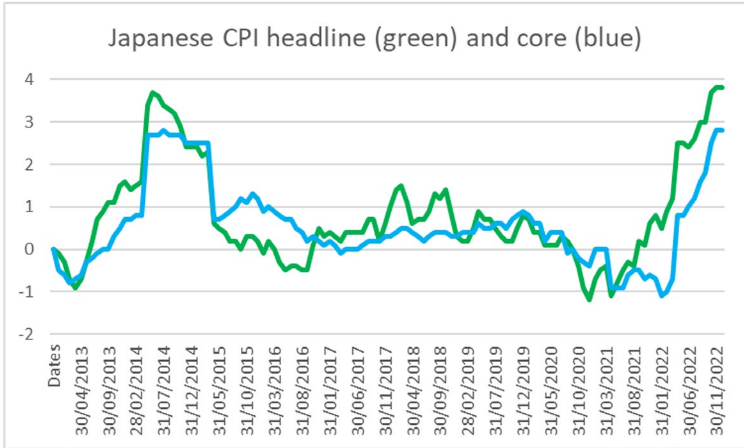
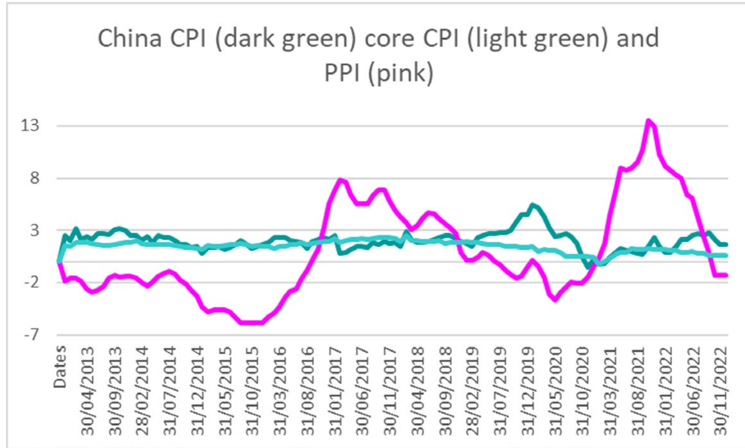


Source: German Federal Statistical Office, INSEE



Source: Japanese Ministry of Internal Affairs



Source: National Bureau of Statistics of China

The **German** headline inflation fell for the second consecutive month due to lower energy prices and state support for gas and district heating. Germany as a strong industrial nation depends heavily on energy prices. Core inflation, meanwhile, has probably remained high as inflation for services rose further. In France, the headline inflation slowed unexpectedly on lower energy and services inflation.

Japanese inflation doesn't show any sign of abating. After the central bank doubled the ceiling for 10-year yields to help improve market functioning, investors are betting that policy makers will relax their yield-curve control policy. Even unscheduled heavy bond buying by the Bank of Japan have not silenced the rumors. As Japan holds $ 2.4 trillion of foreign debt, repatriation of capital due to higher interest rates could have global consequences. For Japan, it will be very difficult to unwind its ultra-accommodative monetary policy. Upcoming political measures in the energy sector, lower commodity prices and a now stronger Yen could moderate inflation in coming months.

In **China** we could even observe disinflation trends, notably on the producer price level (pink) due to sharp price drops in commodities, such as iron ore. The CPI at 1.6% remains modest and has mainly be driven by food prices. The core CPI stayed at or below 1% for eight consecutive months. Prices for consumer discretionary items remained sluggish, reflecting weak consumption. The muted pricing picture results of course from the strict Zero-Covid policy. With the sudden opening, demand will increase over time and cause prices to rise.

Conclusion:
Inflation pressures vary from region to region and largely depend on its composition, economic development and dependencies. We consider the US to be the furthest ahead in fighting price pressure.

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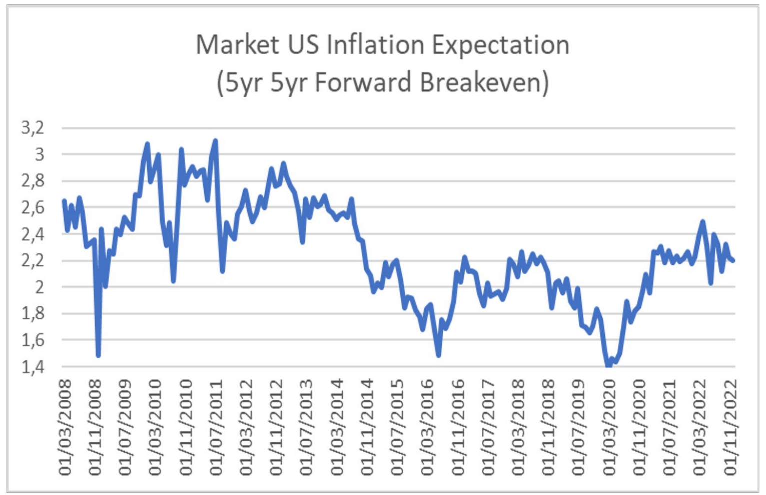
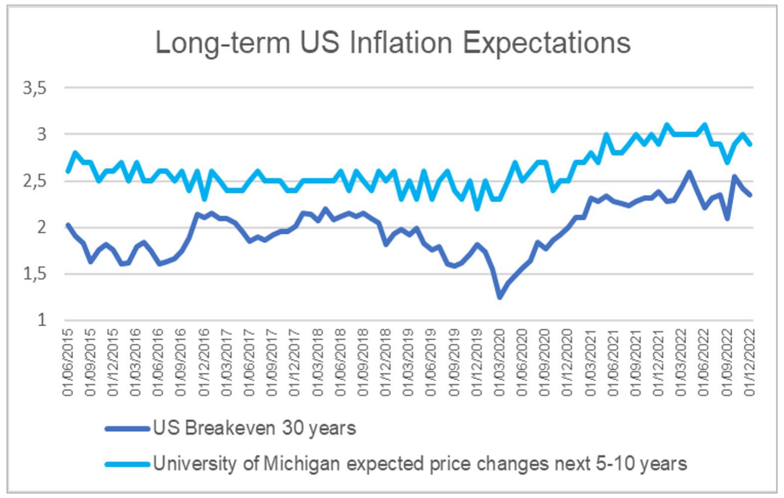
B)Inflation Expectations



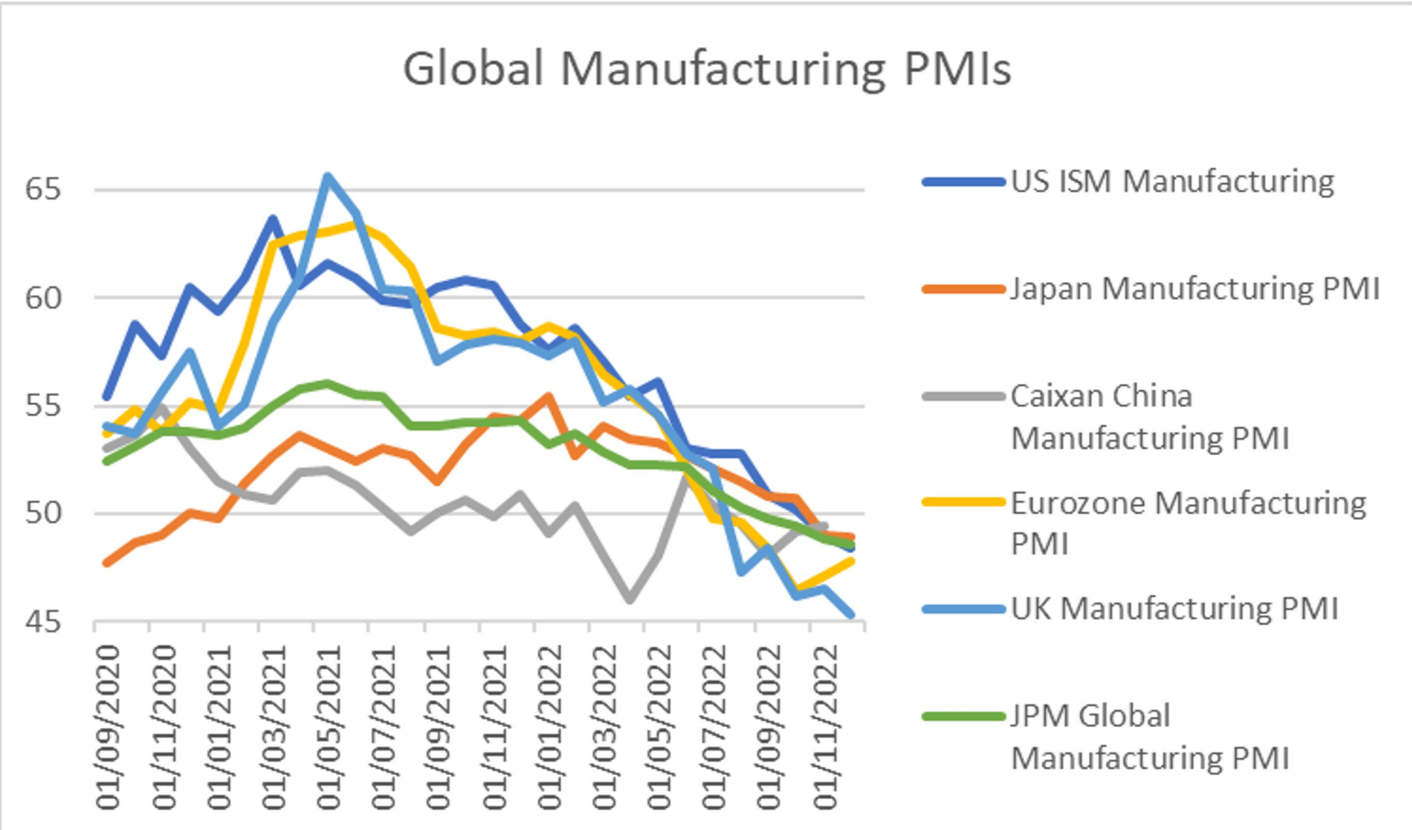
Source: Bloomberg

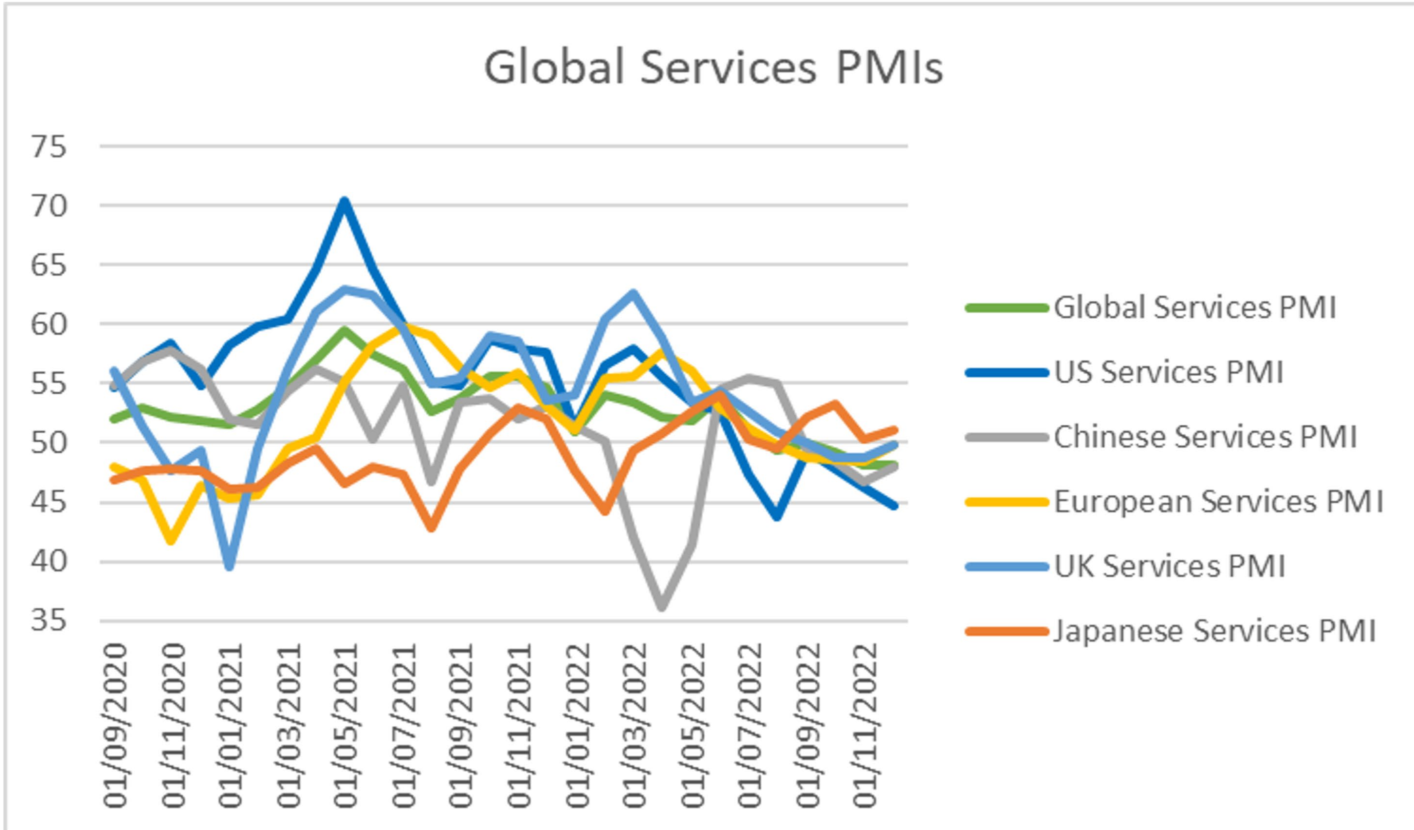


Source: University of Michigan, Bloomberg

Conclusion:
In the most important economic zone - the US - inflation expectations are anchored.

C) Economic Indicators





Source: Bloomberg

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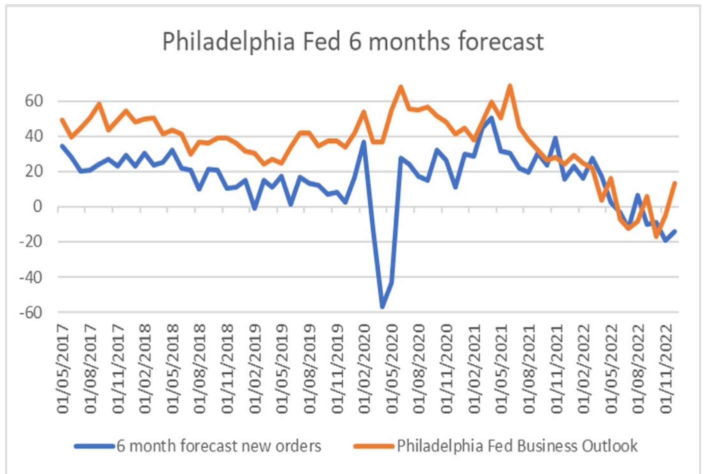
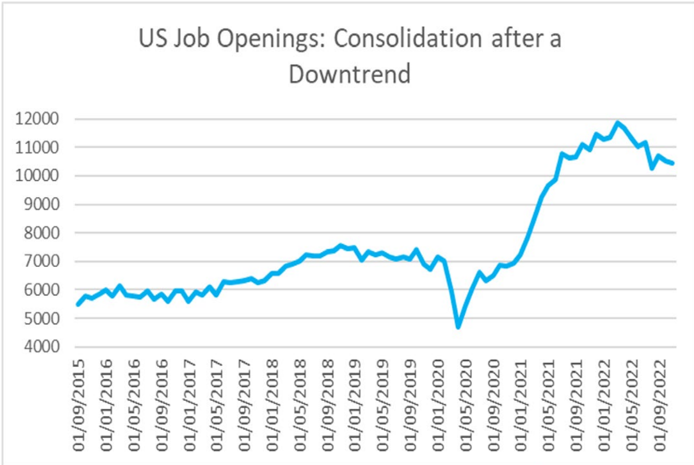
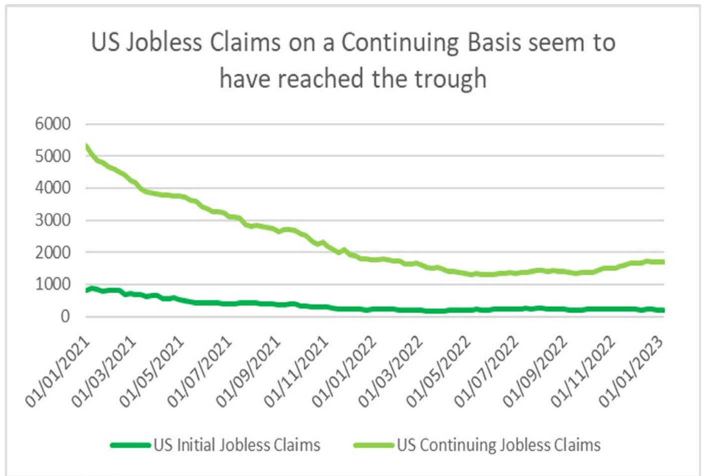


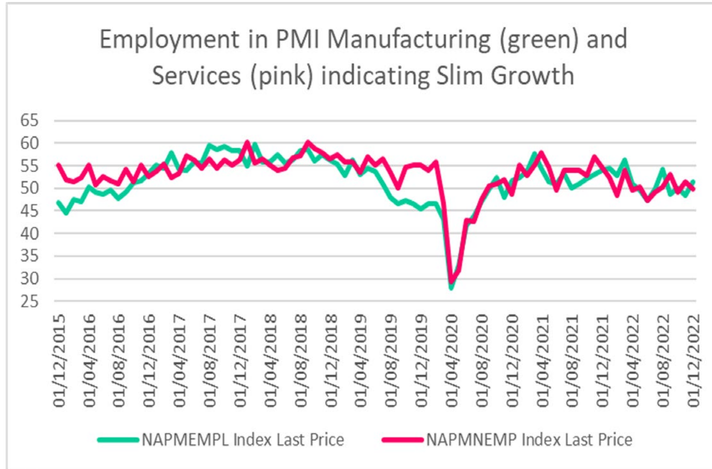
Source: Philadelphia Federal Reserve



Source: Bureau of Labor Statistics



Source: Department of Labor



Source: Institue for Supply Management

Source: Philadelphia Federal

Leading Indicators particularly in Manufacturing point to an economic contraction worldwide. Services hold up better and rather move sideways with the exception of the US. That said, one of the best leading indicators for the US – the Philadelphia Fed – shows a positive outlook. The closely watched labor market is still holding up quite well fueling controversy in respect to monetary policy.

The Economic Surprises Indicators illustrates that investors have been positively surprised by the economic developments in Europe. Asia data, however, disappointed. The US releases have generally met expectations.

Conclusion:

Investors are widely expecting a global recession to unfold. It may even be one of the most anticipated recessions of all time. The US already experienced two consecutive quarters of negative growth last year – and has therefore be in an recessionary environment for a while. Given the data points we would expect rather a better than anticipated outcome. The unexpected and sudden reopening of China also points to a less severe global downturn than what is now reflected in markets.

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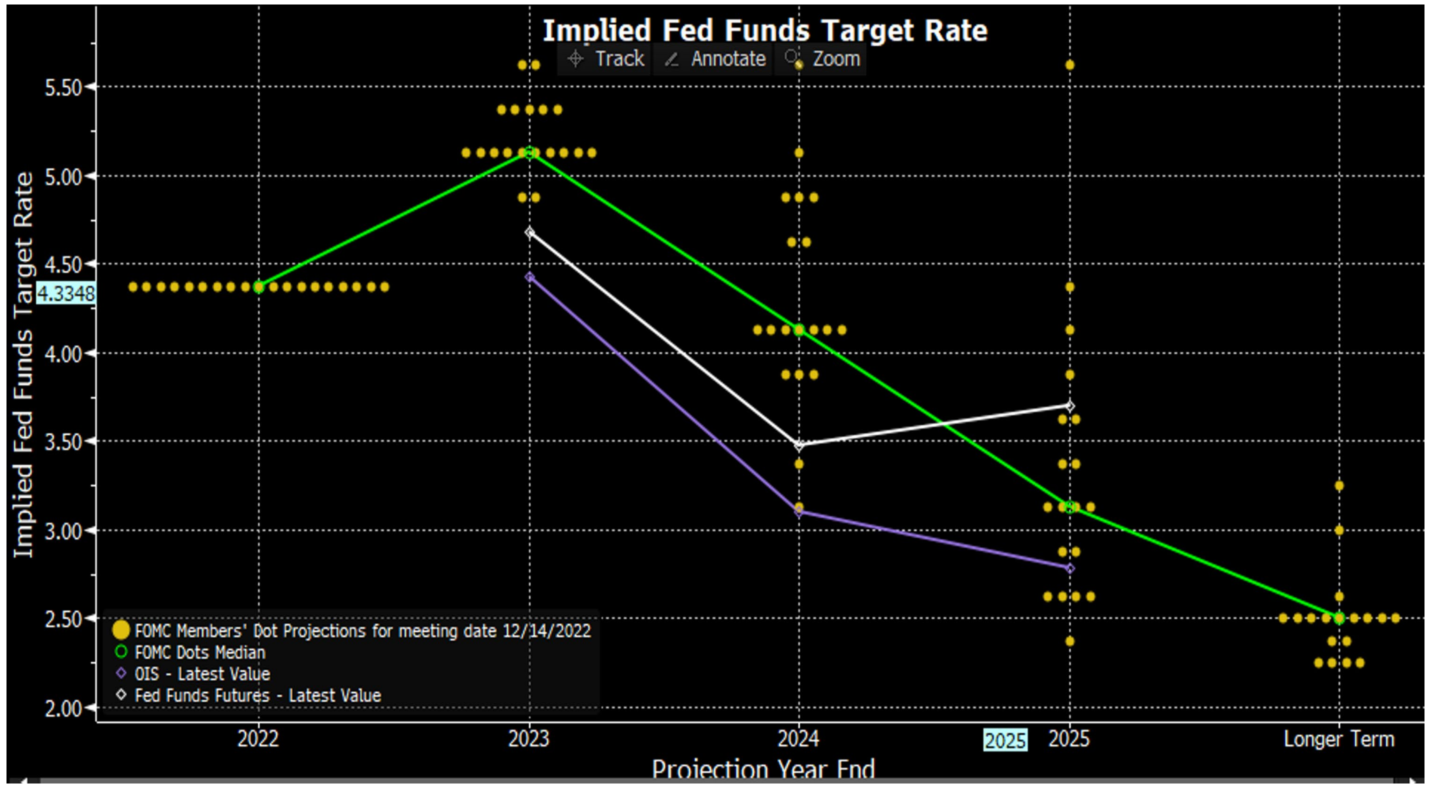
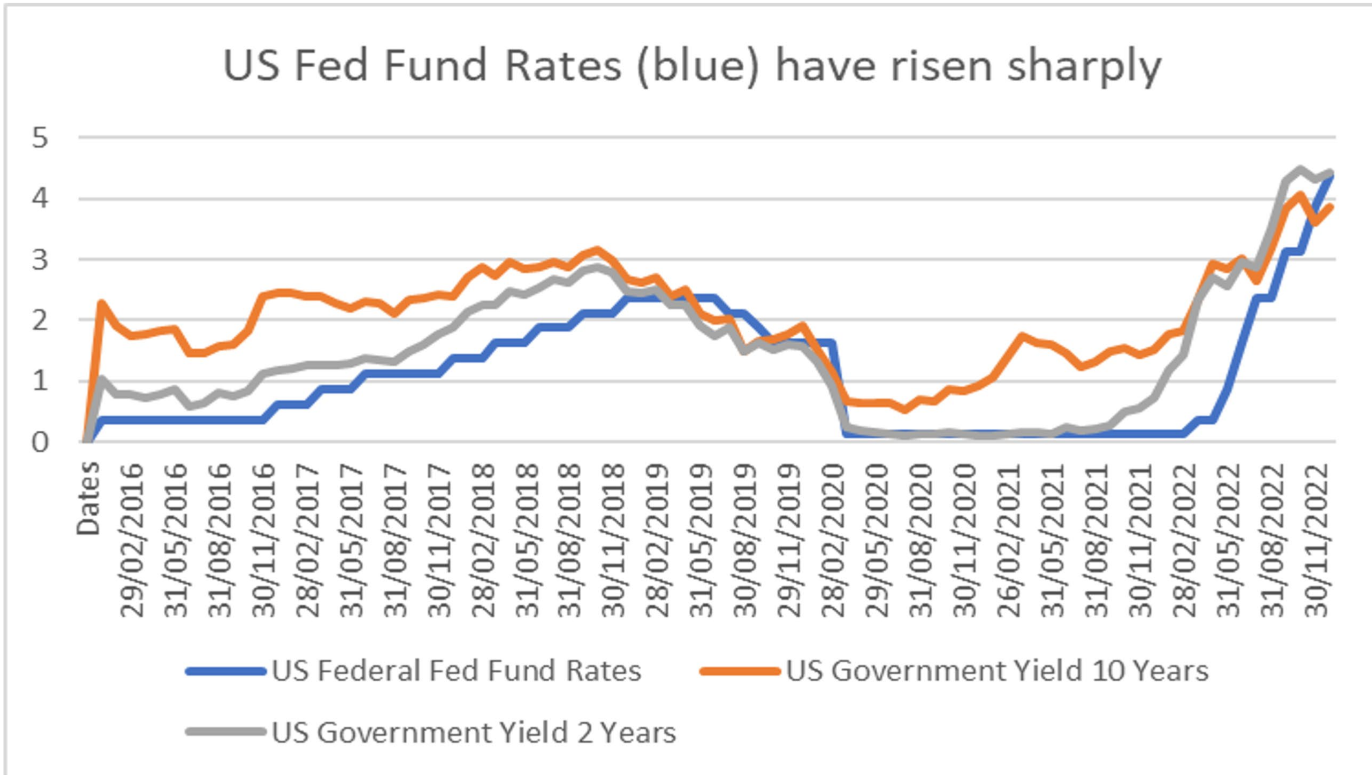
D) Central Bank Policies

"It is clear to everyone, except the central bankers, that the Fed is on course for another major policy error." cited from the 2023 outlook of Brandywine Global Investment Management. While we are not sure if it is a particularly good idea to quote a company which has Brandy and Wine in its name, the general statement seems to reflect common thinking: The Fed is on its best way to overtighten, thereby triggering a deep recession. In fact, the latest FOMC minutes offer harsh words: "A number of participants emphasized that it would be important to clearly communicate that a slowing in the pace of rate increases was not an indication of any weakening of the Committee's resolve to achieve its price-stability goal or a judgment that inflation was already on a persistent downward path."

Conclusion: The Fed acknowledges mistakes. It does all it can to avoid another one. In the 1970s – the time of the last inflation period – the US central bank eased too early. Yet we all know that Fed Fund interest rate increases take time to work out – normally six to nine months. Slowing down hikes and eventually stop should be the obvious response. At 4.5% we seem very close to the top. This alone should support markets, even if there should be no cut this year. Bond markets seem to agree. There are uncertainties, however, in respect to quantitative tightening and international capital flows.



Source: Bloomberg



Source: Federal Reserve, Bloomberg

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E) Corporate Earnings

Fears of a deep recession are widespread. It strikes us that such a scenario should not be reflected in earnings estimates, according to pessimists. We observe that earnings estimates for main indices have decreased considerably (see charts below), but apparently not enough for the naysayers. A recession would indisputably impact the revenue potential for many companies. We would argue that we are by no means in a normal economic cycle. Many of the Covid-induced negative factors are now normalizing and might have a positive impact on corporate earnings. The Chinese openings will further enhance these developments. We would highlight the improvement of the delivery chain situation, reduction of input costs due to lower prices and eventually also labor costs and normalization in inventories.

In addition, inflation caused multiples to contract. Should the inflation situation ease - as we expect - there is room for multiple expansion.

Conclusion: Many investors were literally overrun by inflation and interest rate dynamics. The annus horribilis 2022 has left scars – also in investor psychology and sentiment. Our analysis concludes that particularly for the US, the hard work of interest rate hikes is behind us and the economic as well as earnings picture is brighter than the market is currently expecting. We are therefore overweight stocks.

Earnings Estimates S&P 500

Source: Bloomberg

Earnings Estimates STOXX 600

Source: Bloomberg

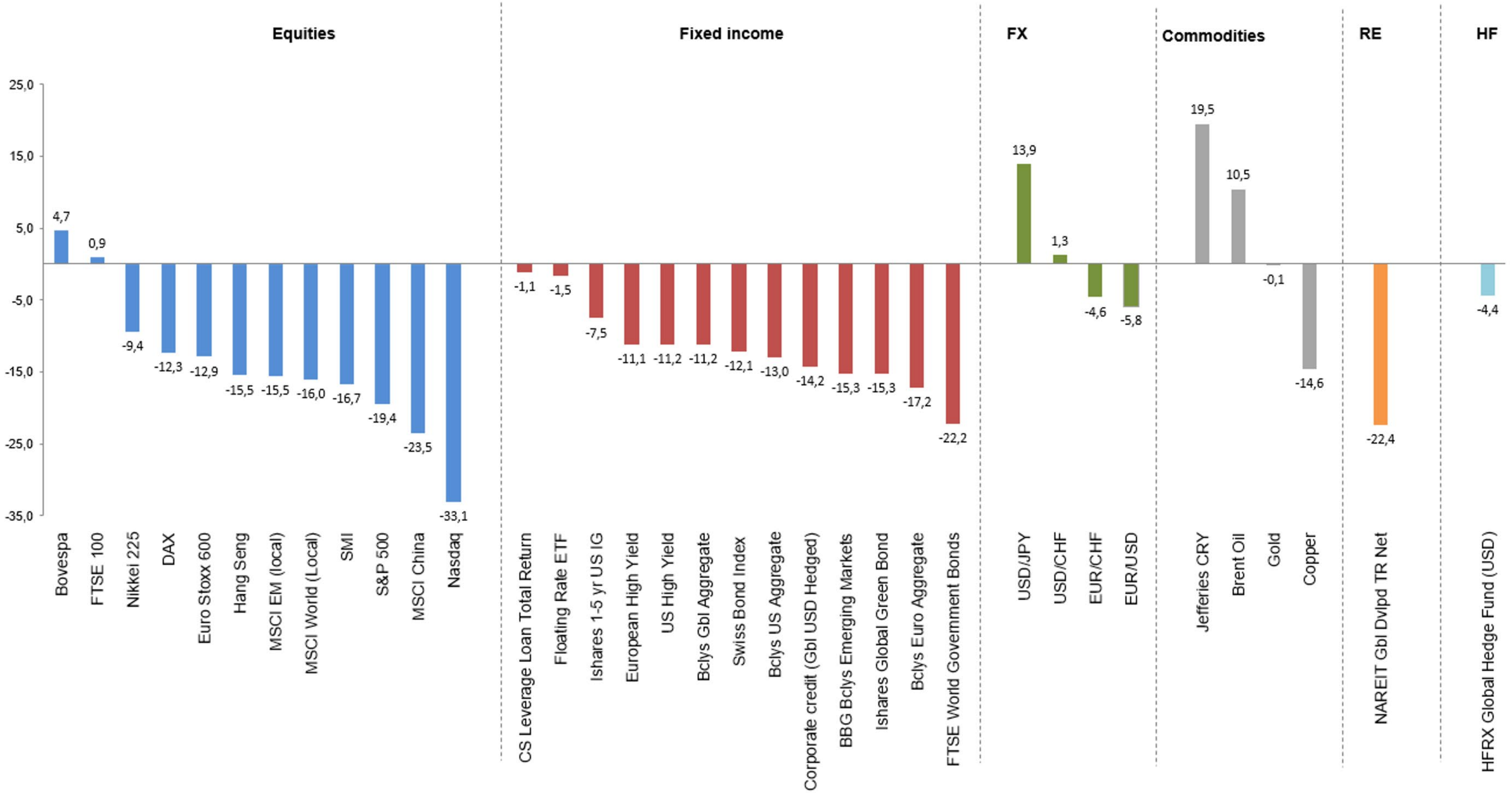
Earnings Estimates Swiss Leaders

Source: Bloomberg

Earnings Estimates Chinese CSI 300

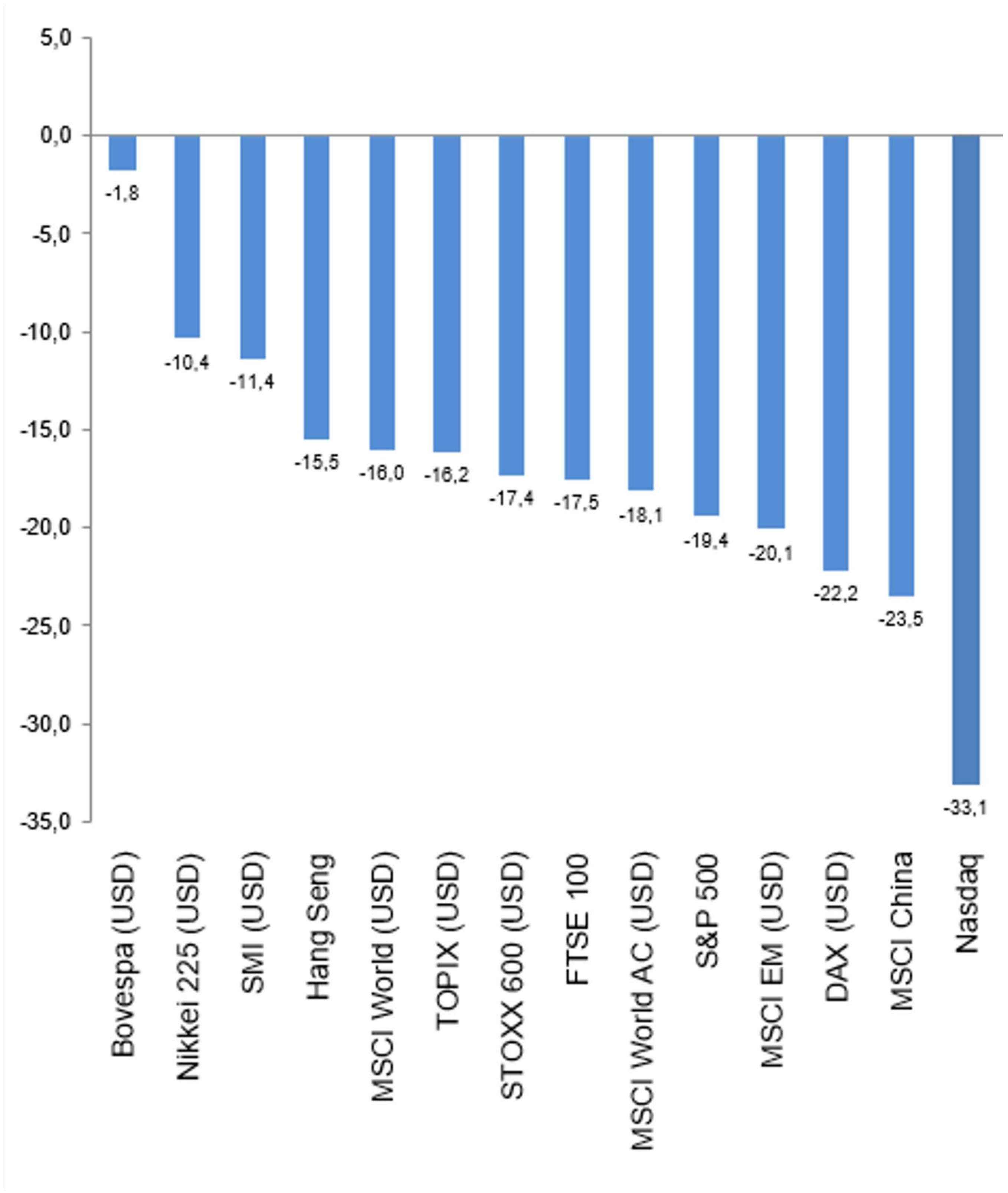
Source: Bloomberg

Performance Major Asset Classes 2022 in Local Currencies



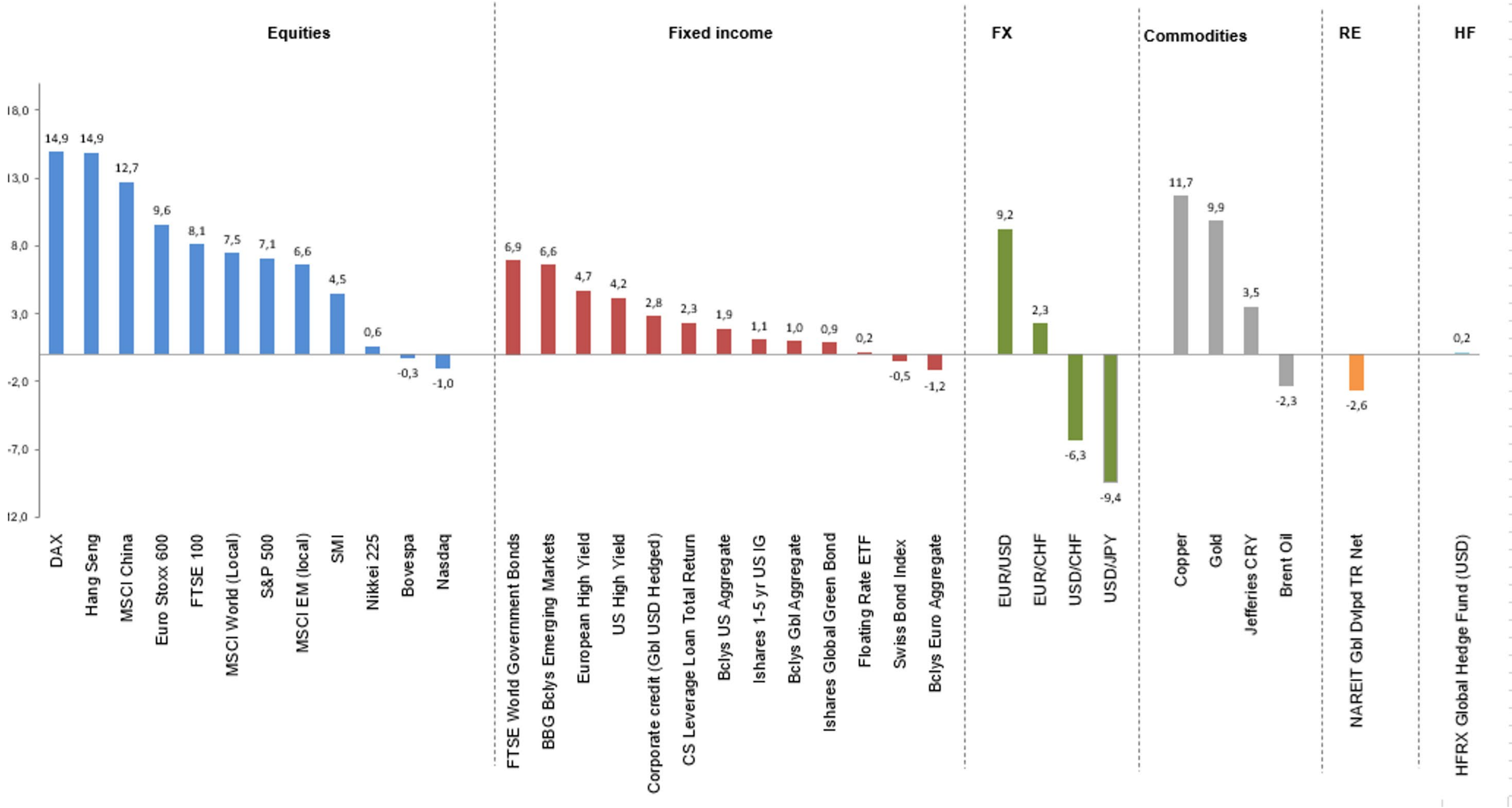
Source: Bloomberg

Performance Equities 2022 in USD



Source: Bloomberg

Performance Major Asset Classes in 4Q 2022 in Local Currencies



Source: Bloomberg

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