AXIOMA
Wealth Management AG

2023 Investment Strategy

30 November 2022

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2022 - Adapting to a New Reality

- In 2022, financial markets have been faced with a harsh reality: a lackluster growth post-pandemic recovery was met with record-high inflation not seen since the 80's. This determined central banks worldwide to embark on a monetary tightening course of an unprecedented pace. After years of very easy money, interest rates in the US have risen from 0.00-0.25% to 3.75-4.00%.
- Geopolitical risks have added to these woes significantly. Our bet on Russian bonds has not played well for us this year. However, over the last months, Russian bonds (with the exception of a few sanctioned ones) have seen a significant surge in price, as most of the issuers continue to be strong financially. Moreover, they continue to show high willingness to pay and to seek alternative ways to fulfill their obligations to bondholders. All the Russian bonds with maturity in 2022 that we hold have been paid in full, although coupons and maturity redemptions take a long time to reach the accounts, due to technical issues – paying agents, clearing systems and banks have significantly increased their compliance procedures in respect to Russian issuers.
- Valuations have seen a brutal correction across asset classes; bonds and stocks have showed a positive correlation over the year.
- Overall, the US economy has been quite resilient so far this year, with demand for services still robust and a tight labor market which fails to give up under monetary tightening pressure. This has been supported by the fact that consumers kept drawing down their pandemic savings.
- Third-quarter earnings season has also brought generally better-than-expected financial results. However, the magnitude of the impact of monetary tightening in the US economy is yet to be seen, as it usually comes with a lag of several months.
- As we approach the end of 2022, the recent market rally due to increased optimism about an upcoming Fed policy pivot, followed by a better-than-expected October inflation reading in the US, has left valuations less compelling than one month before. Nevertheless, fixed-income markets are currently already pricing more rate hikes by the Fed and a moderate recession in the US for the near future.

2023 – Year of the Bonds

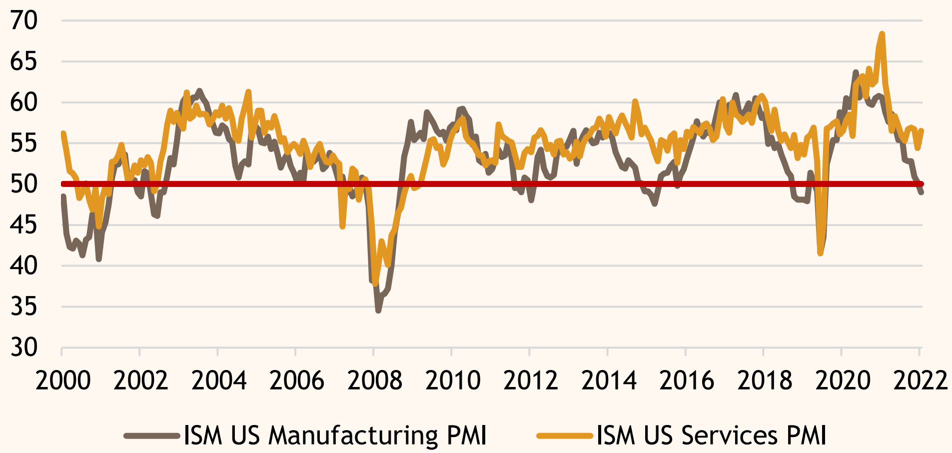
- After a severe repricing in 2022, the risk-return profile for fixed income as an asset class has become very attractive. For example, yield-to-worst on Bloomberg Barclays US Aggregate (Investment-Grade) Index is at 4.4%*, compared to a low of 1.0% in August 2020, while Emerging Markets High Yield Index offers 11.3%* yield-to-worst, compared to a low of 5.7% a few years ago.
- US Federal Reserve is determined to keep raising rates to bring inflation down to their target. As a result, both growth and inflation will see a decline in 2023. Thus, a recession in the US has become almost inevitable, and we expect Fed to revert to rate cuts. We therefore anticipate long-term yields to peak at some point during the first months of the next year.
- The correlation between bonds and stocks will likely become negative again – high-quality bonds will provide valuable diversification in the event of a recession. This diversification benefits were lacking for the last decades because of ultra-low yields. Their return will support significant demand for the asset class.
- After the recent November rally in US Treasuries and a tightening of credit spreads, we expect yields to edge higher at some point in the near future. Due to lingering uncertainty regarding the course of inflation and the magnitude of the economic downturn, we expect the first months of the 2023 to remain highly volatile – this may bring with it advantageous entry points.
- On a 1-3 years horizon however, we expect significant tightening of credit spreads from the current level. This should provide high single-digit to double-digit returns even for a 12-months horizon.
- Compared to previous recessions, corporate issuers have much stronger fundamentals, and will enter in the recession with strong balance sheets which they have built during the pandemic.
- Investors have recently focused predominantly on macro risks and less on single-issuer risks – by engaging in a thorough bottom-up research of single corporate issuers, attractive investment opportunities can be discovered.
- Geopolitical risk will remain elevated, not just in Europe, but also along the US-China relationship axis, and this will add to the volatility of asset prices in 2023.

* As of 30 November 2022

US Economic Outlook

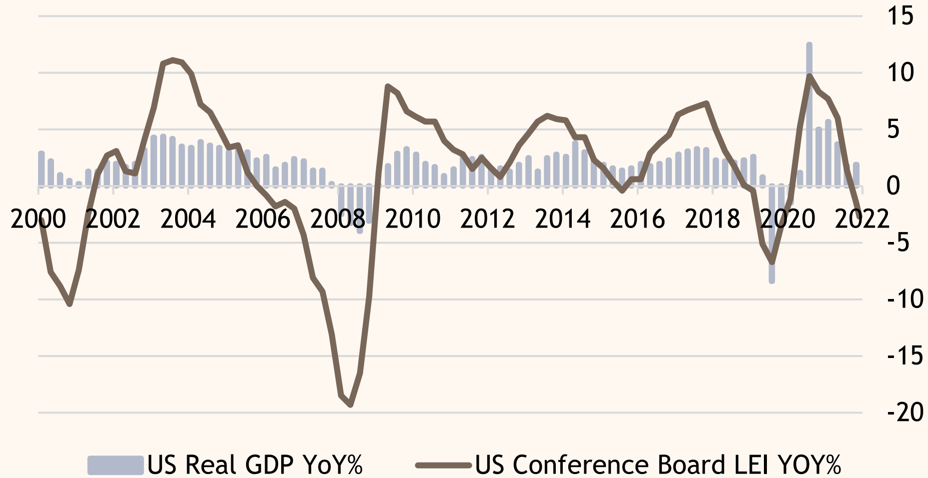
- Although US economy has been resilient so far this year, some of the economic indicators are already in the contraction territory as of latest published data. Manufacturing PMI is in a clear downtrend, and, with inflation still running hot, this provides a challenging high inflation/low growth environment.
- As monetary tightening continues propagating through the economy, the probability of a recession has increased significantly. Our base-case is that of a moderate recession, but its timing is difficult to project. Households have still strong cash buffers built during the pandemic and this, coupled with our expectation that Fed will intervene to avoid a "hard landing", will put a floor under the economic downturn.

Chart 1: Manufacturing PMI in the US is already flashing red



Source: Bloomberg, ISM; 30 November 2022

Chart 2: US Leading Economic Index vs. US Real GDP

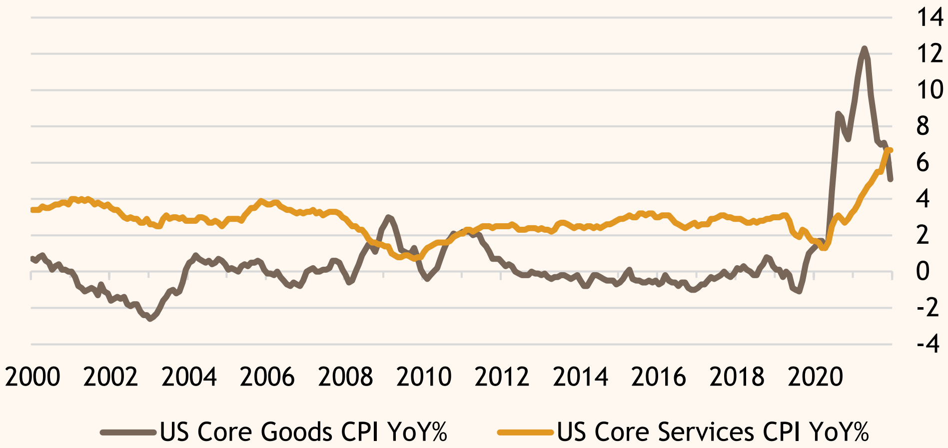


Source: Bloomberg, The Conference Board; 30 November 2022

US Economic Outlook

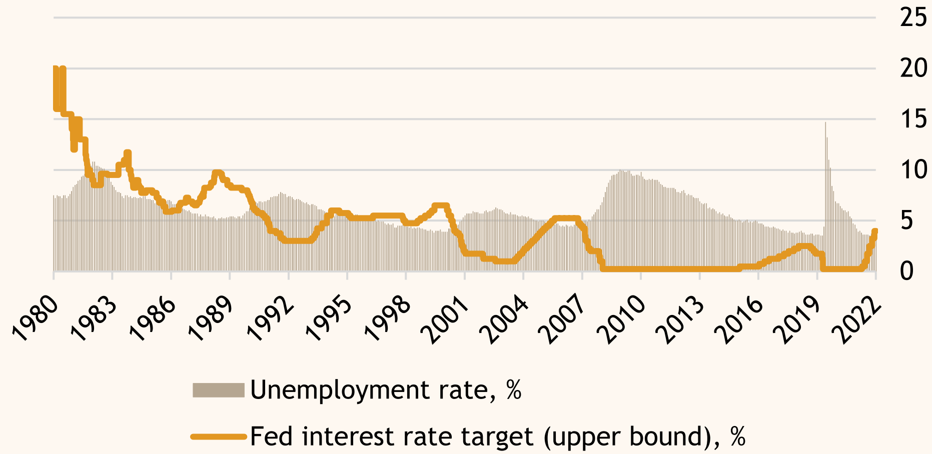
- Inflation is slowing, driven by a moderation in core goods price – the main source of inflation in 2021. However, core services inflation is still rising, driven by wage growth in a still-tight labor market.
- As of October data, headline CPI inflation stood a still high 7.7% year-over-year, core inflation (CPI excluding volatile food and energy) at 6.3%, and Fed's preferred gauge of inflation – PCE deflator – at 6.2%, still far from Fed's 2.0% inflation target.
- A significant rise in unemployment is needed to bring down inflation. However, we believe the unemployment rate will not rise as high as during previous recessions, due to structural changes in the labor market post-pandemic.

Chart 3: Fed eyes core CPI – services inflation is the main concern



Source: Bloomberg; 30 November 2022

Chart 4: When interest rates rise, people loose their jobs, eventually

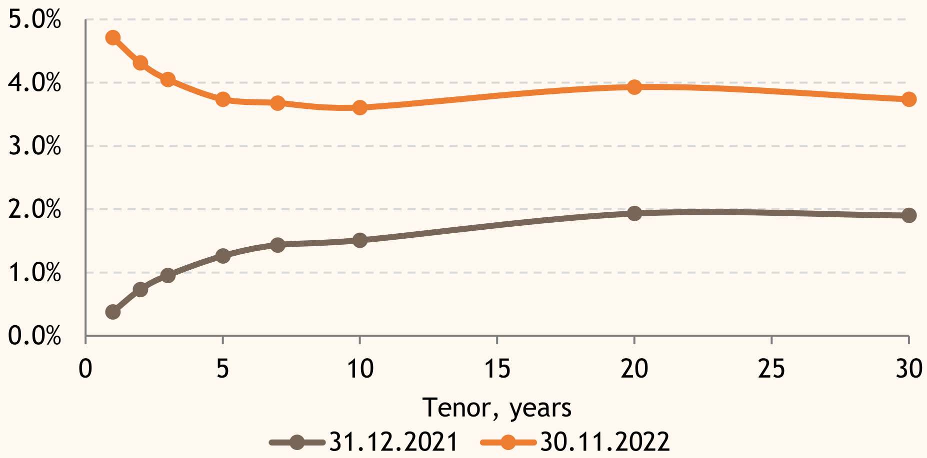


Source: Bloomberg; 30 November 2022

US Monetary Policy

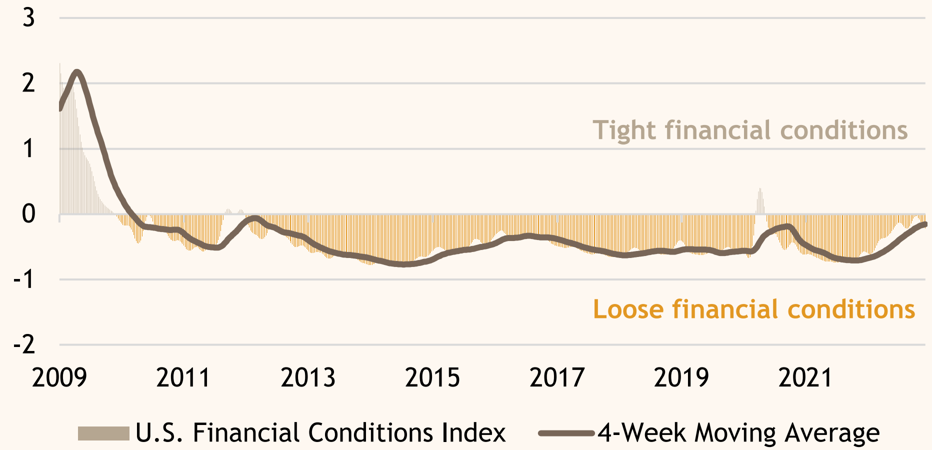
- Fed's narrative saw a drastic change this year - from a view of "temporary inflation" last year, to a very hawkish stance and is very determined to fight for its credibility after last year's policy mistake.
- Fed runs a dual mandate – pursuing maximum employment and price stability. Both latest labor market and inflation data point to further tightening ahead. But, how far can Fed go given the worsening liquidity conditions? Only until something breaks …
- The financial conditions have improved slightly over the last few weeks but are bound to deteriorate further with more rate hikes on the way.

Chart 5: Fed has so far delivered the highest pace of policy tightening in over 3 decades



Source: Bloomberg; 30 November 2022

Chart 6: Chicago Fed Financial Conditions Index (Funding, Credit and Leverage Risks)

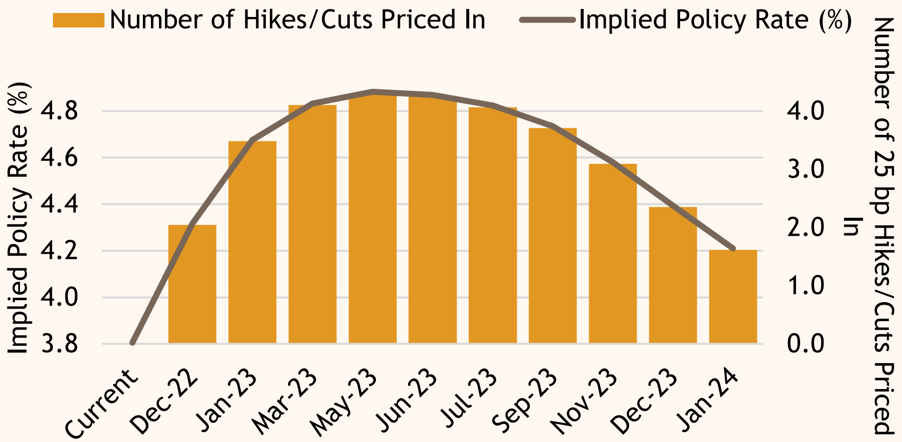


Source: Bloomberg, Federal Reserve Bank of Chicago; 30 November 2022

US Monetary Policy

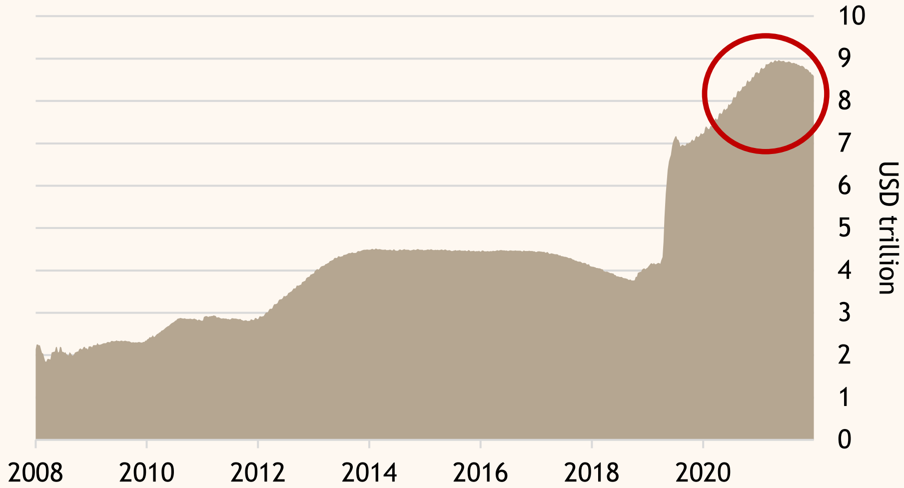
- Markets are currently pricing a terminal rate just below 5.0%. The policy rate will likely peak in the first quarter of 2023, and we believe subsequent rate cuts once recession ensues.
- Fed is currently unwinding its balance sheet by USD 95 billion per month in Treasuries and MBS. We believe the quantitative tightening will have to end at some point in 2023, without the Fed having managed to unwind a significant part of its balance sheet, which currently stands at over USD 8 trillion.

Chart 6: Implied US Policy Rate and Number of Hikes/Cuts



Source: Bloomberg (30 Day Federal Funds Future); 30 November 2022

Chart 7: Quantitative tightening not over yet

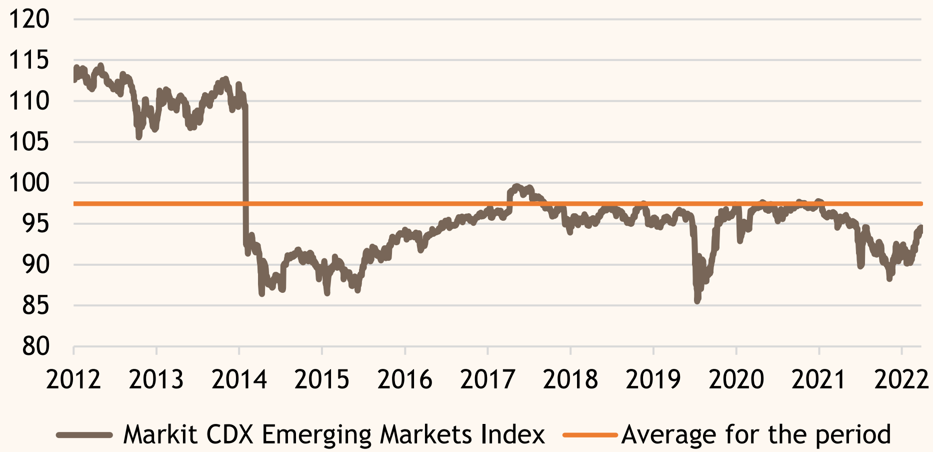


Source: Bloomberg; 30 November 2022

Emerging Markets Outlook

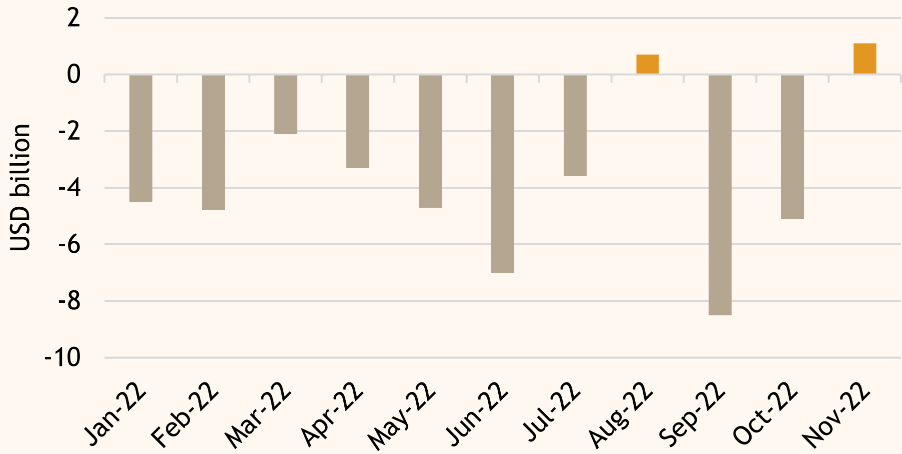
- EMs are more resilient compared to the 2013 EM debt crisis due to several factors: central banks' pro-active fight with inflation, lower current account deficits, larger size of the domestic debt markets. Maintaining fiscal sustainability on the back of rising social pressures will remain the main challenge, especially in Latin America. Things to watch in 2023 will be policy developments in Chile, Colombia and Brazil, after the recent change of power in these countries, and Turkey's elections which are supposed to be held next summer.
- China has been hit by its very restrictive COVID-19 policy, weak consumption and a slump in the property sector. However, recent policy support measures and relaxation of Covid-19 restrictions are improving the economic outlook and with it the outlook for emerging markets as a whole.

Chart 8: Market's pricing of EM risk higher YTD, but lower than the 10-year average



Source: Bloomberg; 30 November 2022

Chart 9: After significant outflows over the year, EM hard-currency bond flows have resumed recently

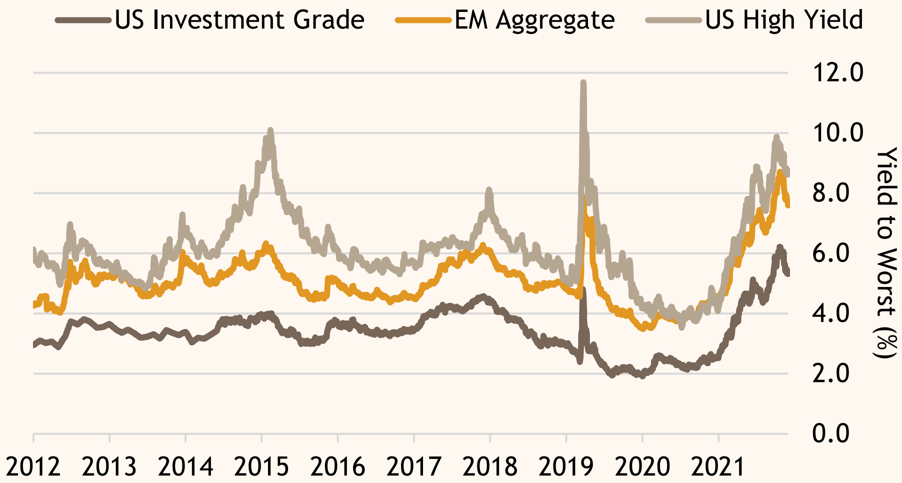


Source: Bloomberg; 30 November 2022

Bond Yields and Credit Spreads

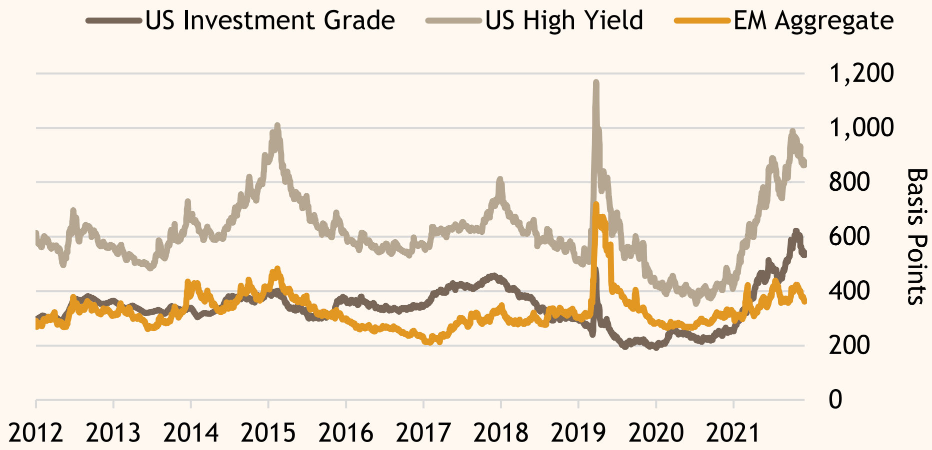
- Investment-grade bond yields have reached levels not seen in decades, providing a very bright outlook for bond returns in 2023.
- Credit spreads have widened significantly over the year, pricing an upcoming recession, although they have somewhat retreated recently, buoyed by optimism regarding a forthcoming Fed policy pivot. From here, there is much more potential for tightening, while the prospective for widening is limited. We believe credit spreads will tighten on a 12-months horizon significantly, given that we expect the recession to be moderate.

Chart 10: Global yields reach attractive levels



Source: Bloomberg; 30 November 2022

Chart 11: Credit spreads have priced a moderate recession



Source: Bloomberg; 30 November 2022

Our Investment Convictions

- In the US, we prefer high-quality investment-grade bonds. We are cautious on the high-yield segments, as their risk premiums will likely widen more in the face of a recession. Although we expect a pick-up in default rates next year, as Fed gradually withdraws liquidity, default rates will likely remain much more contained compared to past recessions, due to still robust balance sheets.
- In Emerging Markets, we also focus on investment-grade bonds, and we prefer corporates with revenues in USD. We believe emerging-market hard-currency bonds currently offer a very good risk-reward profile, with credit spreads at levels comparable to developed-markets high-yield corporate issuers, even though their credit quality is, on average, higher.
- Emerging Markets issuers will represent the major part of our portfolios with a focus on corporate issuers. We will continue to maintain the share of developed countries at the level of 30-40% in order to diversify the EM risks.
- At current valuations, we like Latin America, where political risks have increased risk premia and Middle East, which have seen an improvement in fundamentals due to high commodity prices. We also follow closely developments in Turkey, where we like several strong corporate issuers, but are concerned about the deterioration of macro fundamentals due to unorthodox policies.
- We continue to avoid investing in bonds of Chinese issuers, the main risks of which, in our opinion, are the opacity of corporate decision making, as well as the complexity of legal structures.
- We consider adding duration once we will assert that long-term yields are close to their peak, which will most likely occur at some point in the first months of the next year. Defensive credits with longer duration may thus offer substantial price gains during a recession (as benchmark yields will go down), while their economic risks are contained.
- Bottom-up approach will be crucial for the search of investment ideas, as well as to avoid worsening credits in a year when a deterioration of financial conditions is expected.

Selected Issuers

- **Braskem** (BBB-/BBB-) is a leading petrochemical company, with industrial units spread across Brazil, Mexico, USA and Germany. It is controlled by Odebrecht Group, while Petrobras, Brazilian state oil company is a significant minority shareholder (owns 36% of shares). Although the company reported soft third-quarter results mainly due to lower demand from China, Braskem continues to have a strong liquidity position. The company has been on a sturdy deleveraging path over the last years, being upgraded by both S&P and Fitch to investment-grade status late last year. Braskem's USD-denominated bonds maturing 2030 and 2050 currently trade at yield-to-maturity of 7.2% and 7.8%, respectively.
- **REC Limited** (BBB-/Baa3) is a subsidiary of Power Corporation Limited, which is in turn owned by the Government of India. It is an infrastructure finance company involved in financing projects various segments of power infrastructure, transmission and power distribution. The company services the private sector project developers, state power utilities, central power sector utilities and state governments of India. REC's bonds are rated at par with India's sovereign ratings. We are positive on the outlook of the company, as current policies of the Indian Government are supportive of REC's operating environment. REC USD-denominated bonds with maturities 2028 are currently trading at 6.0% yield-to-maturity.
- **SAN Miguel Industrias Pet** (BB+/Ba1) is a leading rigid plastic packaging company in Latin America, serving beverage, food, personal and home care and pharma markets. The company is well-diversified geographically, with 38% of its revenue sourced in Peru, and the rest across several other countries in Central and South America. The credit quality is supported by the ability to pass through volatility of its raw material costs to customers, which provides protection for the margins, and by the long-term duration of its contracts. The company has been successful in its deleveraging efforts over the last few years, with net debt/EBITDA currently at 2.4x, down from 4.3x at the end of 2020. The main constraint is the relatively small size of the company, although it has grown considerably over the last ten years. SAN Miguel Industrias Pet Bond with maturity 2028 and a is currently trading at a yield-to-maturity of 6.9%.
- **Office Cherifien des Phosphates** (BB+/BB+) is among the top three global phosphate fertilizer producers, and it has access to roughly 70% of the world's phosphate reserves. The company is 70% owned by the Government of Morocco. OCP has reported very strong third-quarter results on the back of high fertilizer prices. We foresee a positive outlook for the company, due to its low cost of production and recently-increased capacity. Net leverage stood at 0.9x as of end-of-September. It has several USD-denominated bond issues, the one maturing in 2031 is currently trading at 6.5% yield-to-maturity and the longest one, with maturity in 2051, has 7.5% yield-to-maturity.

Note: Bond Prices as of 30-Nov-2022

Our Scenario Forecasts

Our **3 market scenarios for a 12-month horizon:**

Optimistic Scenario: 5-year US Treasury yields remain close to the level as on 30 November 2022 in 12 months: 3.75%. Credit spreads tighten by 350 basis points, on average. Average leverage cost for the period: 4.00%.

Base-Case Scenario: 5-year US Treasury yields decline by 25 basis points compared to their level on 30 November 2022, reaching 3.50% in 12 months. Credit spreads tighten by 300 basis points, on average. Average leverage cost for the period: 3.75%.

Worst-case Scenario: 5-year US Treasury yields decline by 50 basis points compared to their level on 30 November 2022, reaching 3.25% in 12 months. Credit spreads tighten by 150 basis points, on average. Average leverage cost for the period: 3.50%. We assume -1.0% loss due to potential defaults in this scenario.

Table 1: Expected total return under the strategy for a 12-month horizon by scenario

Strategy Return	Optimistic Scenario	Base-case Scenario	Negative Scenario
Coupon Component	5.3%	5.3%	5.3%
Price change due to Change in UST Yields	-0.1%	1.2%	2.4%
Price Change due to Spread Narrowing or Widening	12.1%	9.7%	2.4%
Default	0.0%	0.0%	-1.0%
Total:	**17.3%**	**16.2%**	**9.1%**
Return Subject to 25% Leverage	20.7%	19.3%	10.5%
Return Subject to 50% Leverage	24.0%	22.4%	11.9%

Note: Calculations as of 30-Nov-2022, based on Axioma Leveraged Bond Fund Portfolio

Our Scenario Forecasts

Our **3 market scenarios for a 3-year horizon**:

Optimistic Scenario: 5-year US Treasury yields are 25 basis points lower compared to their level on 30 November 2022: 3.50%. Credit spreads tighten by 515 basis points, on average. Average leverage cost for the period: 3.50%.

Base-Case Scenario: 5-year US Treasury yields decline by 75 basis points compared to their level on 30 November 2022, reaching 3.00% in 12 months. Credit spreads tighten by 450 basis points, on average. Average leverage cost for the period: 3.00%.

Worst-case Scenario: 5-year US Treasury yields decline by 125 basis points compared to their level on 30 November 2022, reaching 2.50%. Credit spreads tighten by 250 basis points, on average, from current level. Average leverage cost for the period: 2.50%. We assume -1.5% loss due to potential defaults.

Fig. 14 Expected total return under the strategy for a 3-year horizon by scenario

Strategy Return	**Optimistic Scenario**	**Base-case Scenario**	**Negative Scenario**
Coupon Component	15.9%	15.9%	15.9%
Price change due to Change in UST Yields	1.2%	3.6%	6.0%
Price Change due to Spread Narrowing or Widening	18.1%	14.9%	5.2%
Default	0.0%	0.0%	-1.5%
Total:	**35.2%**	**34.4%**	**25.7%**
Return Subject to 25% Leverage	41.4%	40.8%	30.2%
Return Subject to 50% Leverage	47.5%	47.1%	34.8%

Note: Calculations as of 30-Nov-2022, based on Axioma Leveraged Bond Fund Portfolio

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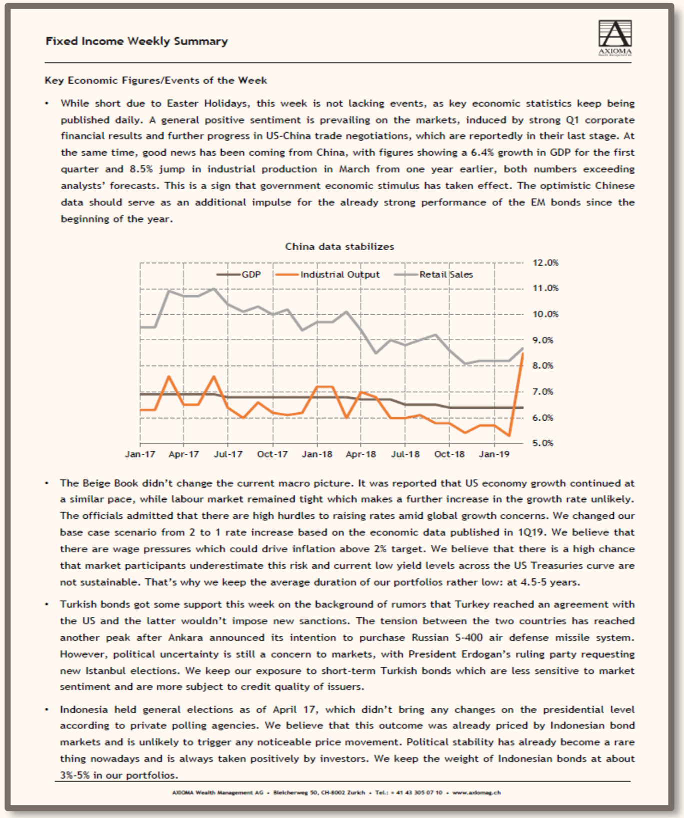

Fixed Income Weekly Summary

Key Economic Figures/Events of the Week

- While short due to Easter Holidays, this week is not lacking events, as key economic statistics keep being published daily. A general positive sentiment is prevailing on the markets, induced by strong Q1 corporate financial results and further progress in US-China trade negotiations, which are reportedly in their last stage. At the same time, good news has been coming from China, with figures showing a 6.4% growth in GDP for the first quarter and 8.5% jump in industrial production in March from one year earlier, both numbers exceeding analysts' forecasts. This is a sign that government economic stimulus has taken effect. The optimistic Chinese data should serve as an additional impulse for the already strong performance of the EM bonds since the beginning of the year.

- The Beige Book didn't change the current macro picture. It was reported that US economy growth continued at a similar pace, while labour market remained tight which makes a further increase in the growth rate unlikely. The officials admitted that there are high hurdles to raising rates amid global growth concerns. We changed our base case scenario from 2 to 1 rate increase based on the economic data published in 1Q19. We believe that there are wage pressures which could drive inflation above 2% target. We believe that there is a high chance that market participants underestimate this risk and current low yield levels across the US Treasuries curve are not sustainable. That's why we keep the average duration of our portfolios rather low: at 4.5-5 years.
- Turkish bonds got some support this week on the background of rumors that Turkey reached an agreement with the US and the latter wouldn't impose new sanctions. The tension between the two countries has reached another peak after Ankara announced its intention to purchase Russian S-400 air defense missile system. However, political uncertainty is still a concern to markets, with President Erdogan's ruling party requesting new Istanbul elections. We keep our exposure to short-term Turkish bonds which are less sensitive to market sentiment and are more subject to credit quality of issuers.
- Indonesia held general elections as of April 17, which didn't bring any changes on the presidential level according to private polling agencies. We believe that this outcome was already priced by Indonesian bond markets and is unlikely to trigger any noticeable price movement. Political stability has already become a rare thing nowadays and is always taken positively by investors. We keep the weight of Indonesian bonds at about 3%-5% in our portfolios.

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- Every week, our in-house team of financial experts and analysts take an in-depth look at how global events are affecting the financial markets and present their forecasts

  Please visit axiomag.ch/insights

- Every month, AXIOMA's fund managers provide an update on AXIOMA Leveraged Bond Fund

  Please visit axiomag.ch/fund

Your Team

AXIOMA's staff are always available to answer your questions and create a tailor-made solution for your specific requirements. Email or call us with any questions, or to make an appointment for a face-to-face meeting at our office in Zurich.

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