

Economic and Market Environment

After a difficult 2022, when most financial assets had negative performance, 2023 started well for global equity markets driven by a rebound in US tech stocks and strong performance in Europe, where the energy crisis has started to abate. Global government & corporate bonds (in yellow & green below) continued their 2022 slide as central banks continued to raise interest rates, in the face of persistent high inflation. Unfortunately, this positive environment only lasted a few weeks and global equity markets started to unravel towards the end of the quarter.



Figure 1 – Global stock market (MSCI ACWI in white), government (Green) & corporate bonds (yellow) – Source: Bloomberg

The recent pullback in global equity markets started with some pessimistic data on inflation and interest rates, and significantly accelerated with three bank failures in the United States and the recent demise of Credit Suisse. Some investors are now wondering if we are at the start of a new financial crisis, and what the implications for their investments are. Fortunately, the three US banks were relatively small and the Swiss government acted swiftly to reduce the risk of contagion from the Credit Suisse failure.

Banking crises are unfortunately as old as capitalism and rapid economic changes tend to create problems. Due to their nature, banks which take deposits and lend them to companies, households and governments are risky ventures. The two major risks are the liquidity mismatch between deposits & loans and the quality of the loan book. These two risks tend to play in parallel and most banks collapse when depositors start to worry about the loan book and stability of a bank and quickly withdraw their deposits. This is exactly what played out in the failure of the three American banks: SVB (Silicon Valley Bank), Signature Bank and Silvergate Bank. Silicon Valley Bank had grown massively in recent years, growing its balance sheet from USD22bn in 2012 to over USD200bn before its failure. The bank benefitted from the massive wealth creation in the Silicon Valley but failed to implement the right risk management practices. In recent

years, the bank was flooded by deposits from successful companies and high net worth individuals and decided to park its excess liquidity in long term US government bonds. As our readers know, we haven't been fans of long-term government bonds for a few years now and SVB's management learnt the hard way what happens to the value of these instruments when interest rates rise. The other major weakness of the bank was its reliance on large 'Twitter savvy' depositors, who all decided to withdraw their money at the same time when they heard about the losses at SVB. The bank quickly collapsed and had to be rescued by American authorities to avoid further financial contagion. The two other smaller American banks, Signature Bank¹ and Silvergate Bank², suffered from their relationship with cryptocurrency and ultimately also failed as a consequence of depositors' flight.

The Credit Suisse collapse is somewhat different, as the Company had been struggling for years and had shrunk its balance sheet by half since the financial crisis in 2008. Once a fleuron of Swiss and global banking, the Company had become a shadow of itself and had struggled in recent years to find a profitable & sustainable business model. The issues were different than for the three failed American banks, but a similar loss of confidence by depositors led to significant liquidity strains and pushed the Swiss authorities to act swiftly and force a merger between Credit Suisse and UBS. For now, the impact of these bank failures has been controlled but the world central banks, governments and financial institutions will likely need to continue their firefighting efforts. The difficult task for central bankers in Europe and the United States will be to continue their fight against inflation, which generally requires an interest rate rise, and to ensure the stability of the financial system, which can suffer from the same rise in interest rate.

As we can see on the graph below, US inflation (in green) is past its peak and appears to continue to go down. Lower oil and gas prices are likely to continue to push down US inflation and the recent regional banking crisis is also likely to reduce economic activity and inflationary pressures. China's inflation is close to an all-time low (in yellow). The country re-opened late last year from its last COVID lockdown, which should boost aggregate demand and also reduce supply bottlenecks. We think that inflation in China is unlikely to surge as, in contrary to the US and in Europe, Chinese citizens haven't received much financial support from their government and so don't have much spare cash to splurge.



Figure 2 – Inflation in the US (green), China (yellow) and Europe (white) – Source: Bloomberg

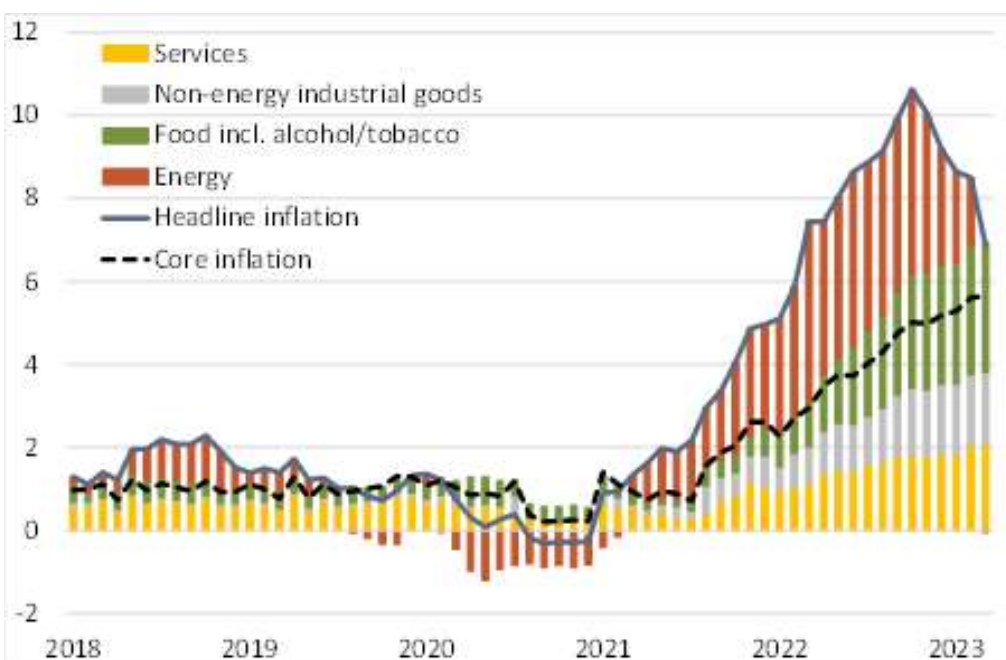
In Europe on the other hand, inflation (in white above) has recently surprised on the upside. Social movements and salary indexation appear to be sustaining core inflation and the energy situation in Europe, while much better than a few months ago, is still precarious. Energy prices in Europe (in yellow on the graph below) have gone down dramatically in recent weeks, but gas prices remain roughly 7x higher than in the United States and a cold spell could quickly push gas & energy prices higher in Europe. We are also starting to see a second wave of effects from the recent spike in energy prices, mainly increasing food prices (in white below) and demonstrations from workers who want to protect their purchasing power. A key problem is that high inflation particularly affects citizens with the lowest income, as energy and food represent a higher proportion of their spending. The less affluent working class also make up a high proportion of employees in essential services (transport, nurses...) and are rightly angry at the erosion of their

¹ <https://www.bloomberg.com/news/articles/2023-03-14/why-did-signature-bank-fail-inside-the-old-school-new-york-bank>

² <https://www.cnbc.com/2023/03/08/silvergate-shutting-down-operations-and-liquidating-bank.html>

purchasing power. European politicians have a difficult situation to deal with, as they need to restrain wage growth and protect the purchasing power of their citizens and the stability of the financial system at the same time. These sometimes conflicting goals will likely result in a bumpy road ahead and some populist measures like increasing taxation on companies' super-profits.

Core inflation and food prices are taking longer to turn than energy



Eurozone inflation (% yoy) and component contributions (in ppt), core: excluding energy, food, alcohol and tobacco.

Figure 3 - Sources: Eurostat, Berenberg

As a result of inflation, global central banks have aggressively raised interest rates in recent months, with the exception of China (in yellow below), which has the luxury to sit tight. The yield on the German six-month government bond (in white below), as well as on American six-month treasuries (in green below), increased significantly over the last 18 months. In the US, this rise in interest rates has started to have an important impact, with a collapse in housing transactions, the failure of some regional banks and finally a slowdown in inflation. It looks like the aggressive medicine is working and the Federal Reserve chairman Jerome Powell indicated in his latest speech that aggressive rate rises are probably behind us. European inflation remains high, and rates are still lower in Europe than in the United States despite having higher inflation.

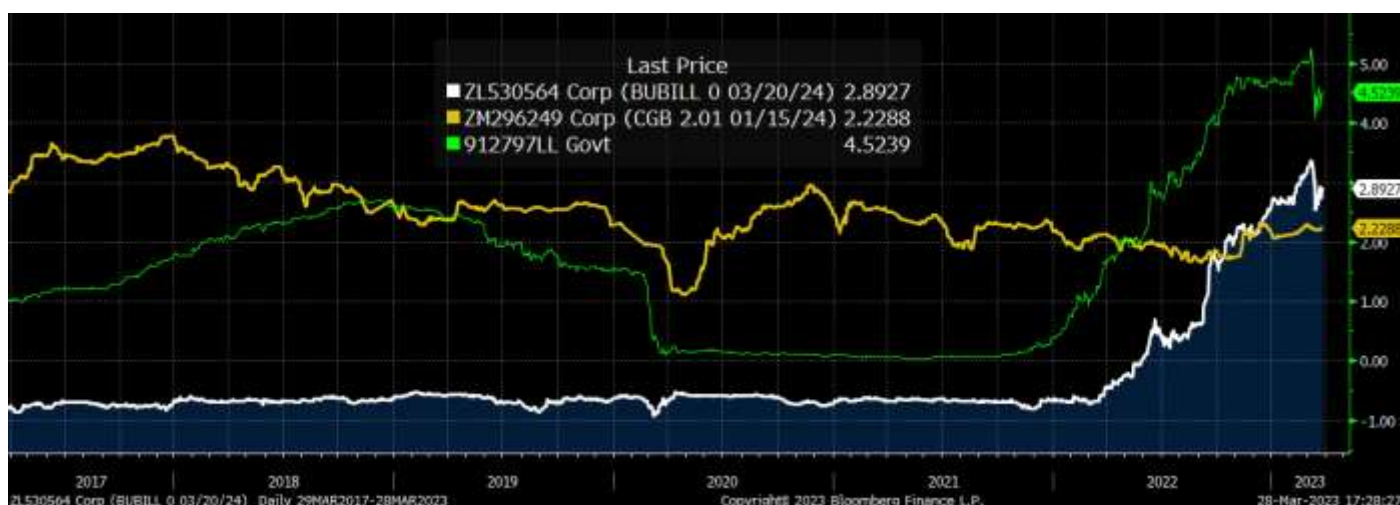


Figure 4 – Interest rates in China, compared to German government 6 months bond yield and American 6 months treasury yield – Source: Bloomberg

For global equity investors, the weight of financial companies in global indexes is somewhat limited³, making up a little more than 10% of the S&P500, compared to more than 25% for technology stocks. Very large American tech companies continue to have a significant impact on the market as we can see on the graph below.

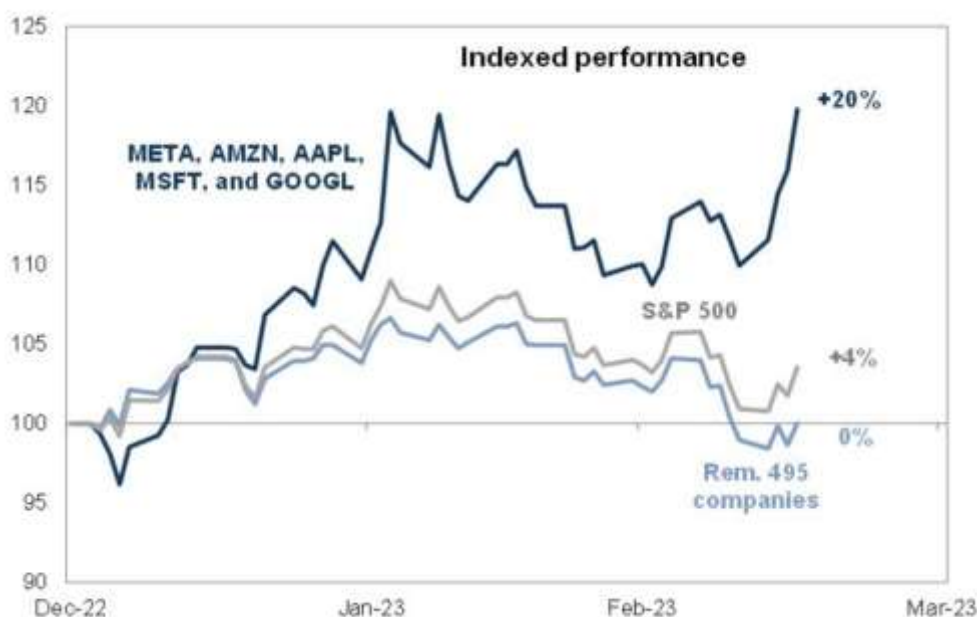


Figure 5 – Source: Goldman Sachs

Banks also tend to be much less valuable than other successful businesses. In France for example, BNP Paribas is worth EUR63bn, which compares to EUR129bn for TotalEnergies or EUR408bn for LVMH. The contrast is even higher in Germany where Deutsche Bank is ‘only’ worth EUR17bn, which compares to EUR64bn for BMW. Even the most valuable bank in the world, JPMorgan, which is worth USD365bn is dwarfed by the likes of Apple and Microsoft, which are worth over USD2trillion each. Banks matter a lot for the world economy, but as long as they are able to continue to do their job, their valuation doesn’t matter that much for global stocks.

While global indexes and the American stock markets haven’t performed very well, earnings growth expectations haven’t changed very much over the last twelve months. Financial analysts consensus continues to expect the S&P500 to have a 2023 EPS (Earnings Per Share) of approximately USD220/share (orange on the graph below), USD240/share for 2024 (blue on the graph below) and USD265/share in 2025 (green on the graph below). Most of the underperformance in 2022 was therefore driven by a de-rating of the market.

³ <https://investingforbeginners.com/historical-sp-500-industry-weights-20-years/>



Figure 6 – S&P500 2023 EPS – Source: Bloomberg

The stock market is driven by **earnings** and the **price you pay for these earnings** (price x earnings). The ‘P’ in the equation can move very quickly but doesn’t go down indefinitely and the long-term performance of the stock market is mostly driven by the nominal growth of the EPS. Over the last five years, we have seen significant earnings growth and as earnings expectations continue to be good for global equity markets, we can only hope for positive returns for multi-year investors.

Our convictions

When we founded TreeTop after decades of experience in the financial market, our idea was to bring the global stock market to the Belgian investor. The rationale was and remains that most investors remain too much invested in their own country and in assets they supposedly know better, like Belgian real estate, European stocks & bonds... and not enough in global champions which can deliver better performance and should be un-correlated to the Belgian economy. More than ever as Europe and Belgium struggle economically, we think that global diversification makes sense for small and big investors alike. The return of inflation as well as the rise of interest rates in the Western world creates an additional hurdle, as a number of financial assets and even some real assets, like office real estate, become much less attractive.

Our solution at TreeTop has been to offer the global stock market first through high conviction concentrated global funds, then through the global index and now more and more through quantitative value strategies. Two years ago, sensing that global growth stocks were very expensive, we switched part of our and our client’s assets to equity value strategies through the ‘Dogs of the Dow’. This has served us relatively well and allowed us to limit the damages of a brutal 2022. Never completely satisfied though and always looking for better solutions, we recently discovered through our studies of financial markets the ‘S&P500 Buyback Free-cash-flow’ (SPBUYFUT). Our first observation was its incredible track-record outperforming most significant indexes over the long and medium term. As of end of March 2023, an investor who invested in the SPBUYFUT at the start of 1994 made 78x his/her initial investment (16% annual return) compared to 14x his/her initial investment in S&P500 total return (9.7% annual return). As a lot of investors don’t have a 30 year investment horizon but tend to invest for 5, 10 or 15 years, we also computed the average annual total return over rolling five year periods and compared it to the MSCI ACWI Total return index. Not only did the buyback index do a lot better than the global index, it never delivered negative five year returns figures unlike the MSCI ACWI.

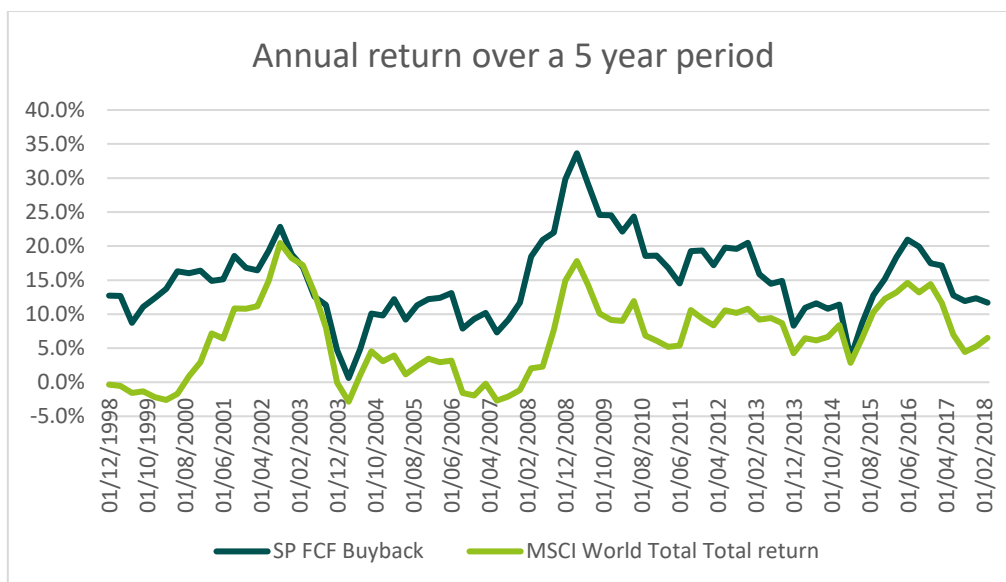


Figure 7 – Source: Bloomberg, TreeTop Calculations

Standard & Poor’s, the organization computing this index, explains that the S&P500 Buyback FCF Index “is designed to measure the performance of the top 30 stocks with the highest free cash flow yields among the 50 most liquid stocks in the S&P500 Buyback Index weighted by free cash flow yield”.

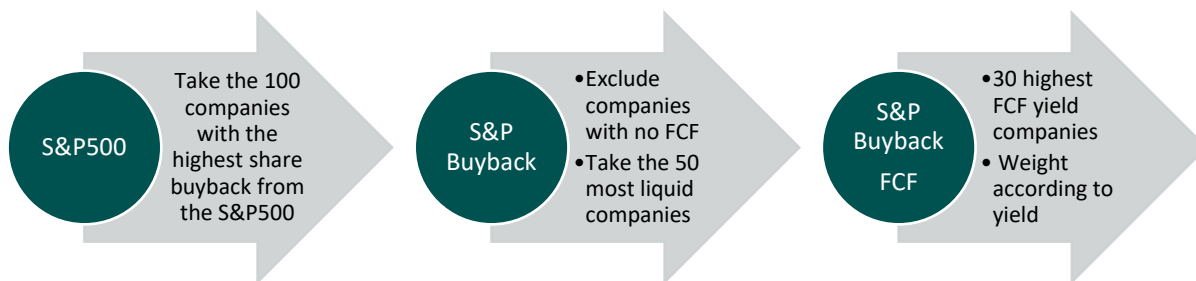
It relies on five filters, a combination that we think is the major reason behind its excellent performance. The first condition is that every stock must belong to the S&P500, one of the most liquid indices in the world, which can be summarized as the 500 largest and most valuable US listed companies, making up ~80% of the total value of the US stock market. These companies tend not only to be bigger but also more stable than the average listed company. These large US stocks are also mostly managed for the interests of long-term shareholders; unlike say a large Chinese bank or a Japanese conglomerate, as activist shareholders make sure that management act on their behalf.

The second restriction is to take the 100 stocks with the highest share buyback ratio of the S&P500. Share buybacks are a financial decision by the management team of a company, and authorized by its board of directors, to use excess cash to buy back the company’s shares. A share buyback is generally made by a management team when they believe that the stock of the company is undervalued and represents a better investment opportunity than investing in growth or doing an acquisition. A share buyback is an interesting indicator as management generally knows much better than anyone else how a business is doing and when they think the ‘value’ of the business is much greater than its stock price.

Then, a free-cash-flow yield is calculated for each of these 100 companies and any company which does not generate positive free cash flow is excluded from the list. Free cash flow can be summarized as ‘cash earnings’ or the cash generated by a company each year available for investors. As the value of an investment is the discounted sum of the future cashflows available to an investor, the more free cashflow a company generates, the more valuable it is. The yield is the price divided by the free cash flow per year and the higher the yield, the less you pay for a given amount of free cash flow. This third criteria is interesting as free cash flow is an important indicator of the company’s financial health and the yield, similar to the price/earnings ratio, is a valuation tool.

The fourth criteria consists of taking the 50 companies with the highest average traded value (ADVT) and the fifth criteria reduces the universe to 30 stocks by excluding the 20 companies with the lowest free cash flow yield, basically the most expensive ones. Finally, each criteria is run again every three months and each 30 investments is weighted according to their free cash flow yield. Cheaper positions have a bigger weighting as they should hopefully generate better returns⁴.

⁴ No guarantee of result or performance



We think that the mix of criteria based on size & liquidity reduces the risk of financial accident significantly. Buybacks by small companies using leverage can quickly lead to bankruptcy. The free cashflow yield criteria allows one to build a concentrated portfolio at reasonable valuation. We are pleased to offer this strategy very soon through various TreeTop products as we think it will be a good complement to our global passive and active investment strategies⁴, which tend to be growth biased. Please feel free to contact our team of financial advisors if you have any questions and we wish you happy investing in the meantime.

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