



Managers' Letter  
2<sup>nd</sup> Quarter 2023

The header image shows two men, Jacques Berghmans and Félix Berghmans, in business suits. They are positioned in front of a background that includes a green line graph and a dark, rocky landscape.

*Jacques Berghmans and Félix Berghmans*

## Economic and Market Environment

As we write the newsletter, we are happy to share that global equity markets, after a few turbulent weeks, rebounded very strongly with the MSCI All Countries World up over 10% so far this year. The overall good performance hides significant discrepancies though with the technology index NASDAQ leading the pack, up over 30%, followed by the Japanese index the NIKKEI 225. The MSCI Europe also generated decent performance, up close to 8%<sup>1</sup> but large industrial stocks tended to have more muted performance. The US market, if you exclude the tech heavyweights of Google, Facebook, Microsoft and Apple, barely moved this year, with the Dow Jones Industrial only up a low single digit percentage.

American technology stocks generally rebounded strongly this year, after a significant period of underperformance in 2022, mainly due to the implementation of aggressive costs cutting measures to protect earnings. More recently, the sector was boosted by the public release of the artificial intelligence tool ChatGPT generating significant excitement among the public and investors. This boosted the prospects of Microsoft, an investor in ChatGPT, and of NVIDIA, a leading semi-conductor company and a new member of the trillion-dollar market capitalisation club. In Europe, the performance was mainly driven by lower recession fears, a buoyant luxury sector and a boom for semi-conductor stocks. The Japanese market was driven by reforms focused on better shareholder returns and by a weak yen, helping Japanese exporters.

Another positive is the general slowdown of inflation in the United States and Europe, which after peaking at 10% in the US and 8% in the Eurozone, is now at the more manageable level of 4% and 6%, respectively. This decline in inflation was mostly driven by lower energy costs with oil & gas prices much closer to their pre-pandemic levels than their recent peaks. As we have explored in previous newsletters, the United States is awash with cheap energy supplies, and energy prices there are likely to remain lower for longer. The situation in Europe is more complicated, as it is very reliant on imports, and Russian gas is still an important source of energy for the eurozone. Nevertheless, the European governments continue to actively build alternative energy supplies like large Liquefied Natural Gas terminals, wind turbines and solar parks. In Asia, inflation has never really been a problem over the last two years, and recent data in China indicates that there is more risk of deflation than inflation. The Chinese economy, unlike its Western counterparts, has generally struggled to recover from the COVID-lockdowns with high youth unemployment and low business confidence. The problems lie with the very strict implementation of COVID rules and little financial help given to households and companies, which has put tremendous pressure on small companies. The economic problems are also compounded by a real estate crisis, which is likely to take a long time to resolve. One positive effect of this sluggish recovery is the excess capacity in the Chinese economy, which is holding inflation back and lowering international demand for energy products like oil.

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<sup>1</sup> As of the 22<sup>nd</sup> June 2023

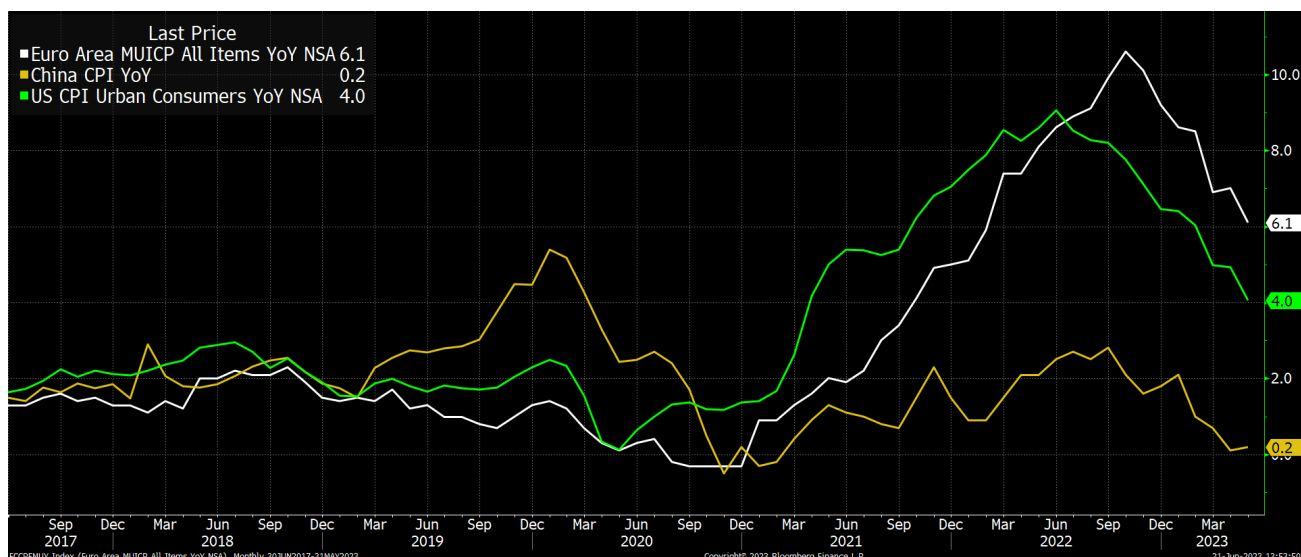


Figure 1 - Inflation in the US (green), China (yellow) and Europe (white) – Source: Bloomberg

Despite better headline inflation numbers, American and European central banks continue to worry about inflation with both the ECB and the FED planning further interest rates rises. The rationale of central bankers is that core inflation (which excludes energy prices) continues to be at least twice their long-term target of 2%. Both American and European economies are now seeing unusually fast wage increases and have very tight job markets, especially the United States. At TreeTop, we don't think we, or anyone else, has the ability to predict what the long-term levels of inflation will be. We observe though that inflation prior to the COVID crisis was unusually low compared to the long-term historic trend. We also observe that positions in lower paid service jobs, like truck driving and waitressing, struggle to find applicants. Large profitable companies like Amazon now offer better pay for zero qualification jobs than for qualified nurses in some countries, which is likely to create further upward pressure on wages. Finally, a declining workforce driven by an ageing population could result in tight labour markets in the US and Europe for decades to come, especially if people continue to vote against immigration.

For investors, higher inflation and interest rates cause several dilemmas. One of the key risks is to lock in savings for long periods at rates below inflation. We continue to be very cautious about investments in fixed income, especially in instruments with maturities above 2 to 3 years. Most government and high-quality corporate bonds continue to yield less than the current inflation rate. In a normal economic and financial situation, long-term fixed income instruments generally have a higher yield than shorter maturity instruments. In the current markets though, 2 year US and European government bonds have a higher yield than 10 year instruments. Basically, the market believes that inflation and rates will come down significantly in the next five years. We think this is not a risk worth taking as the returns will be modest if all goes well but could be awful if things go wrong.

Higher interest rates don't only have an impact on fixed income investments - they can also affect other investments and the real economy. Highly levered corporates and some private equity deals are already struggling<sup>2</sup>. We haven't seen yet a wave of bankruptcies of highly levered companies, but the financial conditions are certainly much tougher than five years ago. The real estate sector is also under pressure as it is heavily reliant on debt financing and had become much more expensive in recent years as rental yields compressed. The most exposed markets are those reliant on variable rate mortgages, like Sweden, or short-term fixed mortgages, like the United Kingdom, which are facing an acute crisis. Swedish residential real estate is already down 15% from the peak and it looks like there is more to come<sup>3</sup>. In the United Kingdom, the 'mortgage timebomb' is making headlines every day, as there are millions of borrowers who need to refinance in the next few years and will face a steep increase in repayments. The most miserable actors are commercial real estate developers facing the perfect storm of lower selling prices and increasing financing and

<sup>2</sup><https://www.bloomberg.com/news/articles/2023-06-20/private-equity-firms-exposed-by-unhedged-risk-interest-rates-surge?fromMostRead=true>

<sup>3</sup><https://corporate.nordea.com/article/81585/swedish-housing-market-false-dawn>

construction costs. Thankfully, mortgage rates are not variable for most American and European homeowners, limiting the probability of an acute liquidation crisis.

Fixed mortgages, a relatively healthy balance sheet and a buoyant job market, also limits the pressure for the American consumer, one of the largest global economic drivers at USD17.4tn (nearly equivalent to the whole Chinese economy). Wage increases now appear to be outpacing inflation<sup>4</sup>, especially for the poorest Americans without a college degree. This significant development should continue to be a major support for global economic growth.

#### Household Debt and Credit

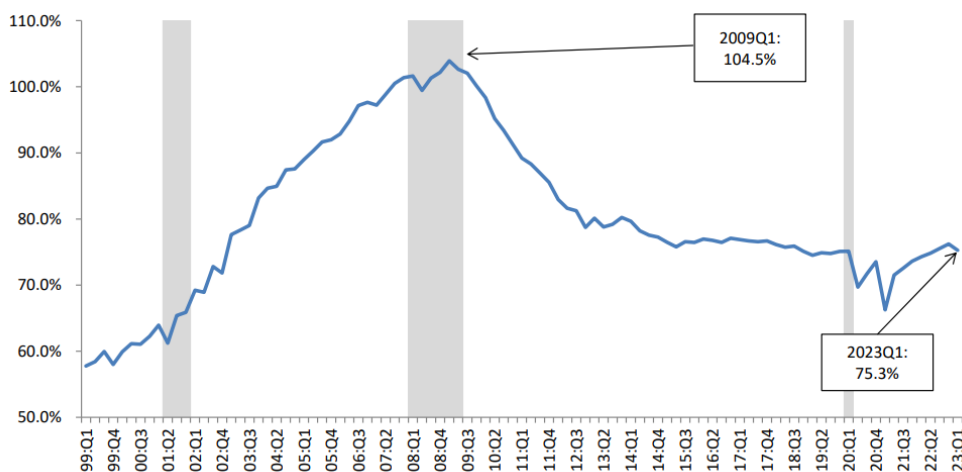


Figure 2 – Household Debt & Credit (Source: RBC Equity Research on US Banks, June 2023)

#### US Wages Exceed Inflation

Wage gains have lagged inflation over the past two years but that is changing

Change in median earnings (YoY, inflation adjusted)

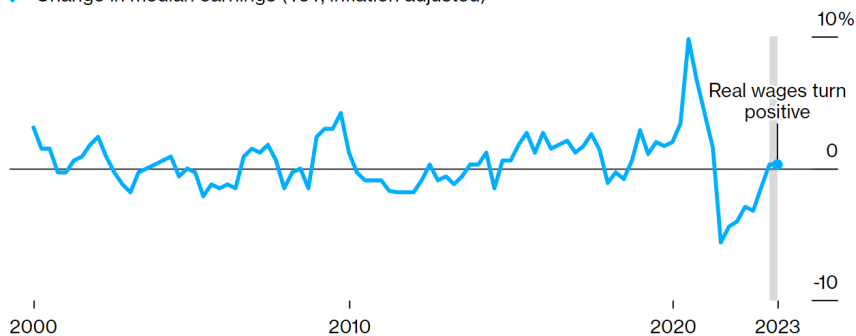


Figure 3 – Source Bloomberg

A last major risk of higher interest rates, as we have seen with the American banking crisis at the beginning of the year, is the potential impact on the financial system. In a recent financial stability review<sup>5</sup>, the European central bank summarized the situation as follows:

*“The recent failures of a number of US regional banks and the takeover of a Swiss bank have invited closer scrutiny of bank exposure to long-term fixed income securities, the stability of wholesale uninsured deposit funding and latent business model challenges.”*

<sup>4</sup> <https://www.bloomberg.com/news/articles/2023-04-18/us-paychecks-are-outpacing-inflation-giving-fed-fodder-for-hike>

<sup>5</sup> <https://www.ecb.europa.eu/pub/financial-stability/fsr/html/ecb.fsr202305~65f8cb74d7.en.html>

### a) Euro area banks' unrealised losses on bonds held at amortised cost

(Q3 2018-Q4 2022; left-hand scale: € trillions, right-hand scale: € billions)

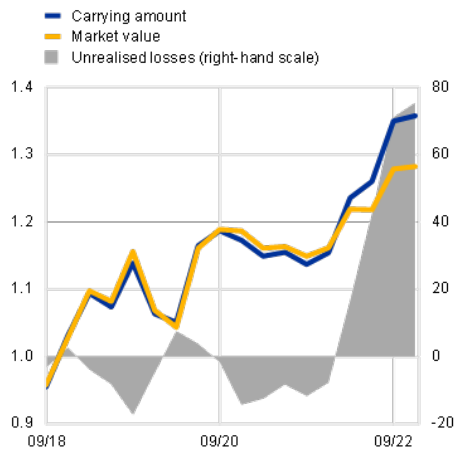


Figure 4 - Source ECB & calculations, May 2023

In other words, the major risk for European banks, especially for the ones with large mortgage/bond books with fixed interest rates, is that their funding rate (deposits) increases faster than the rates they charge on their assets (loans they make, such as mortgages and corporate loans). The recent debate in Belgium about the low interest rates on deposits shows the tension between savers, who feel fleeced by low interest rates, and the Belgian central bank who is concerned about the Belgian financial system<sup>6</sup>. In the graph on the left, we see the increasingly large amount of unrealized bond losses in the euro banking system. There are two caveats to this problem. First, as the title indicates, the losses are unrealized, meaning the prices could rebound and are unlikely to crystalize if bonds are held to maturity. Second, the total amount at EUR75 billion seems large but must be compared to the EUR16tn European economy. The regulators are certainly keeping a close eye on how these numbers evolve and at the liquidity of the financial system, but we wouldn't be surprised if this situation created a few more financial shocks in the months to come.

In conclusion, a rapid increase in interest rates, especially after the long period of near zero rates since 2009, is likely to have unintended consequences. Some European banks could face problems, and real estate and private equity are not the one-way bets they have been. Highly indebted corporates and even sovereign states could face issues. In this uncertain environment, we believe that a highly diversified global equity portfolio remains an interesting investment. Valuation multiples, unlike those for fixed income and real estate, remain in line with their long-term averages and earnings tend to grow at least in line with inflation over the long term. There are certainly pockets of over-valuation and we always advise against chasing the latest theme, but a globally diversified portfolio of stocks should continue to be the bedrock of one's savings.

<sup>6</sup> <https://trends.levif.be/a-la-une/banque/taux-du-livret-il-ne-faudrait-pas-que-les-belges-deviennent-infideles-a-leur-banque/>

## Our convictions

Our investment style tends to gravitate towards 'value' investments or stocks which trade on relatively low valuation multiples. This investment strategy helped our performance in 2022 compared to the overall market but hasn't performed as strongly in 2023. A lot of the best performing stocks this year are American technology companies trading at a premium to the overall market. **NVIDIA** and **TESLA**, two very large contributors to the index performance this year due to their massive market capitalization (USD1,043bn & USD799bn), trade on 55x and 53x 2024 PE respectively and are up more than 100% since January. Other names like **MICROSOFT** and **AMAZON** also trade on elevated multiples after strong performance this year. We don't want to dismiss these companies as they are exceptional businesses, run by outstanding management/entrepreneurs, but we don't want our clients, as well as ourselves, to be over-exposed to these names. As we recommend a core investment in a global index fund, where investors have a large exposure to these American large tech companies, we also try to diversify exposure away from these expensive stocks.

Our best performer last year, **FUFENG**, a leading Chinese amino acid company, is having a more difficult 2023. Our main investment argument is that the company, after years of consolidating its market thanks to savvy investments and a best-in-class cost structure, has finally gained pricing power. The thesis worked well last year, and the company delivered outstanding earnings and stock performance. So far this year, the stock hasn't performed well, though no worse than the Chinese equity market overall. We think that most investors in the stock have a short-term outlook and after a bumper 2022 and are looking for a quick way to crystalize their gains. While we don't think that **FUFENG** will significantly beat earnings expectations going forward, the stock trades on extremely low valuation multiples (2.5x forward PE) with a very attractive 15% dividend yield. We think that the company can sustain its high margins given its 'moat' and that the stock will progressively re-rate as a consequence.

Other major investments are in the "Dogs of the Dow", or high yielding US stocks, where performance was mixed as some sectors performed well while others were more disappointing. The major reason behind this more muted performance is that earnings expectations in the US, after a very strong recovery following the pandemic, have been slightly pressured in recent months. Several large companies saw their earnings rebound massively in 2021 and 2022, as the world economy re-opened following the pandemic, and most households were flushed with savings and wanted to consume. Most businesses also had strong pricing power giving them the ability to raise prices beyond cost inflation. Overall, as we can see on the graph below, the Dow Jones saw its margins expand significantly in 2021 (yellow line) and peak at the beginning of 2022. This led to an excellent index performance (white line).



Figure 5 - Dow Jones profit margin (in yellow) and price (white), source: Bloomberg

This started to unravel in 2022 as the Russia-Ukraine war led to massive energy inflation and a general increase in interest rates. However, we are glad to observe that margins appear to have stabilized which should bode well for future earnings growth and returns<sup>7</sup>.

As always, we are available for any questions you might have and wish you a nice summer.

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*Data & Information as of 30<sup>th</sup> June 2023*

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