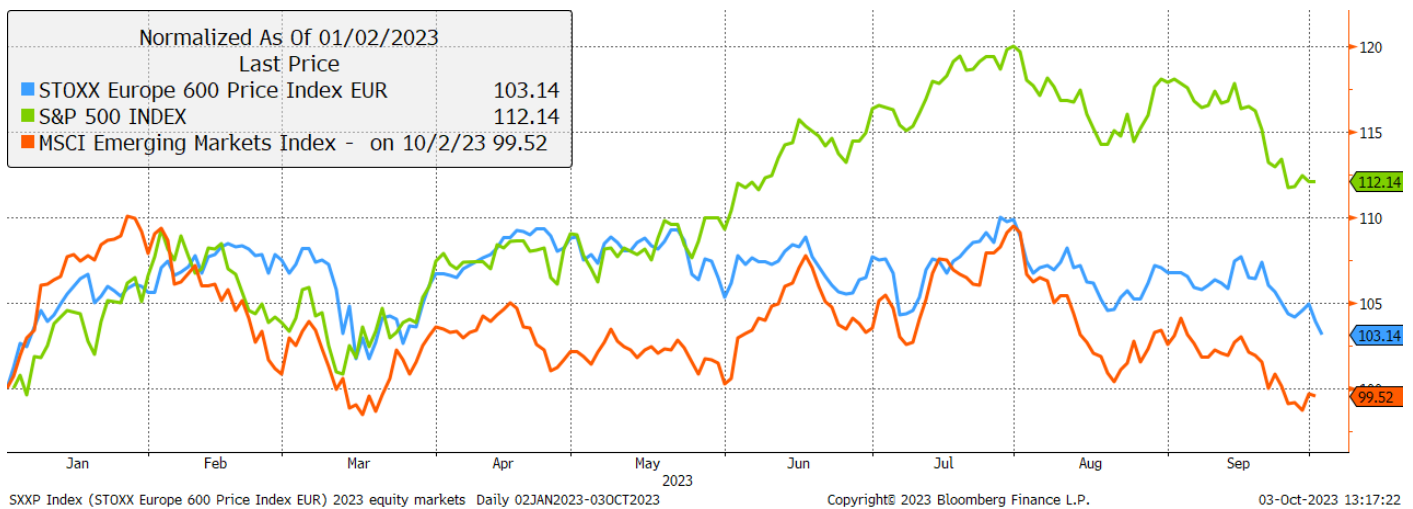


Economic and Market Environment

As I am writing this newsletter, we are seeing some tension in the world financial and real estate markets, despite mostly good global economic news. Most economic indicators continue to be very positive with employment at an all-time high in the United States and most of Western Europe, good corporate profitability and rapidly falling inflation. Despite all the good news, most major equity markets have drifted down in recent weeks. The US market (in green on the graph below), whilst still up quite a bit for the year, reached a peak in July and has been under pressure since then. The European market (in blue below) has been mostly stable but has not generated much return so far this year, and emerging markets (in orange below) have continued to underperform this year.



Six months ago, rapidly falling inflation, good corporate earnings and the absence of a recession would have likely been taken very positively by global equity markets. Unfortunately, rising yields have thrown a spanner in the works. To understand the current situation, we should rewind the clock and look back at the decisions taken by the world central banks and governments over the last three years. Faced with unprecedented economic & financial disruption at the beginning of the COVID pandemic, Western governments ramped up spending significantly and central banks cut interest rates to zero and flooded the financial system with liquidity. The medicine worked, and while Europe and the United States had a deep recession, it was followed by a historically quick economic recovery. In financial markets, analysts even talked about a COVID boom, quite ironic as the ‘boom’ went in parallel with a global healthcare catastrophe. This ‘economic boom’ also created several problems, mainly a bubble in fixed income & real estate, badly damaged government balance sheets and the seeds for faster inflation. Overall though, the economic situation at the end of the pandemic was precarious, but would have been manageable if Vladimir Putin didn’t decide to invade his neighbour and cause the worst energy crisis in Europe since the 1970s. After two years of pandemic, politicians now had to face a global energy crisis, the need to welcome millions of refugees and spend enormous amounts on weapons to defend Ukraine. All of this had to be done with stretched government budgets, whilst facing higher inflation. It was

the first time in decades that Western governments could not simply spend their way out of a crisis. They also could not rely on the help of central banks, which started to aggressively raise interest rates to fight inflation. As we see in the graph below, the two-year US government bond yield (in orange) increased from 0% in mid-2021 to 5% within just twelve months, one of the fastest increases ever. This rapid change in interest rates toppled a few banks, a UK prime minister, violently burst the bubble in long term government bonds and is making real estate investors in the Western World very nervous. For most of the last 18 months though, most investors thought that the recent spike in short term yield was temporary, and that rates would eventually go down, lifting asset prices and making the life of embattled real estate developers and overleveraged companies a lot easier. The hope for an eventual fall in interest rates was reflected in the rate curve, as the 10-year US bond has had a lower annual yield than two-year bond since mid-2022.



Figure 2 – US government bonds yield (2Y in orange vs. 10Y in blue) – Source: Bloomberg

This all changed over the summer when short-term rates and then long-term rates started to climb even faster. In July 2023, the US central bank ('The Fed') announced its decision to raise its interest rate further to between 5.25% to 5.5%. The raise pushed short-term treasury yields higher, as expected, but then longer-term interest rates, as shown by the blue curve, started to quickly catch up with shorter term rates. This means that investors in the US treasury market now expect yields to stay higher for longer, and demand compensation for that. The exact cause behind the fast increase in long-term yields will always be difficult to pinpoint, as it is market driven, but the end of quantitative easing and the aggressive fiscal policies and large government deficits in the US, certainly had a large role to play. The rise in long-term rates also has a deeper impact on the economy affecting real estate, the financial system, and the cost of financing for companies. Mortgage rates in the US are now at a 22 year-high, significantly depressing housing transactions, and a lot of businesses are having to pay double-digit interest rates when refinancing, having been able to raise money at single digit rates just two years ago.

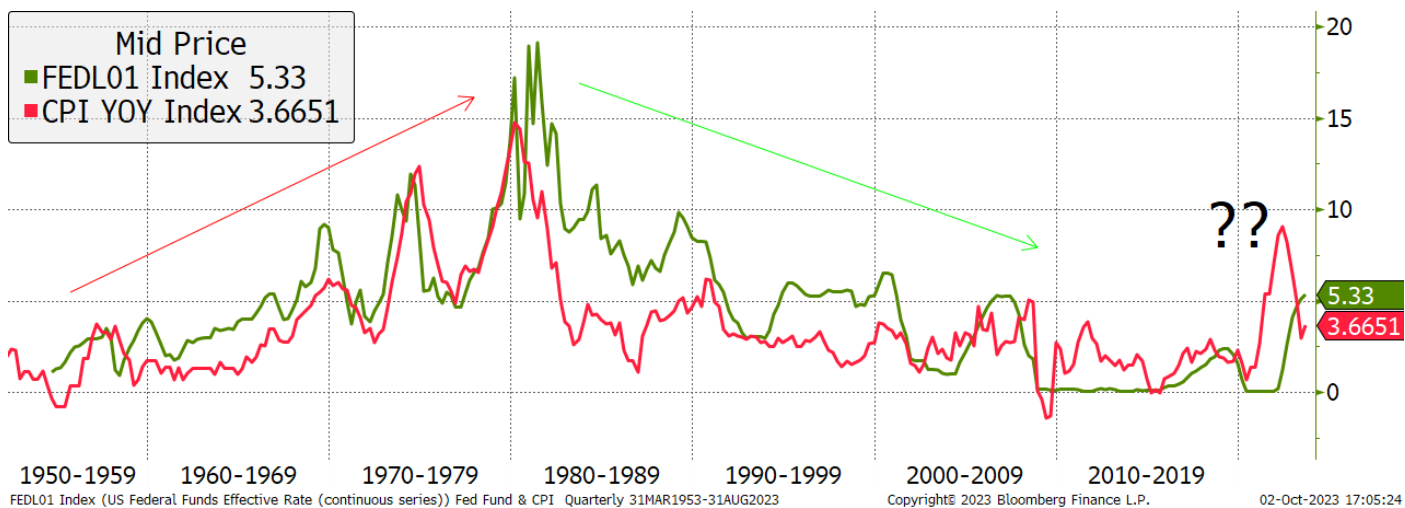
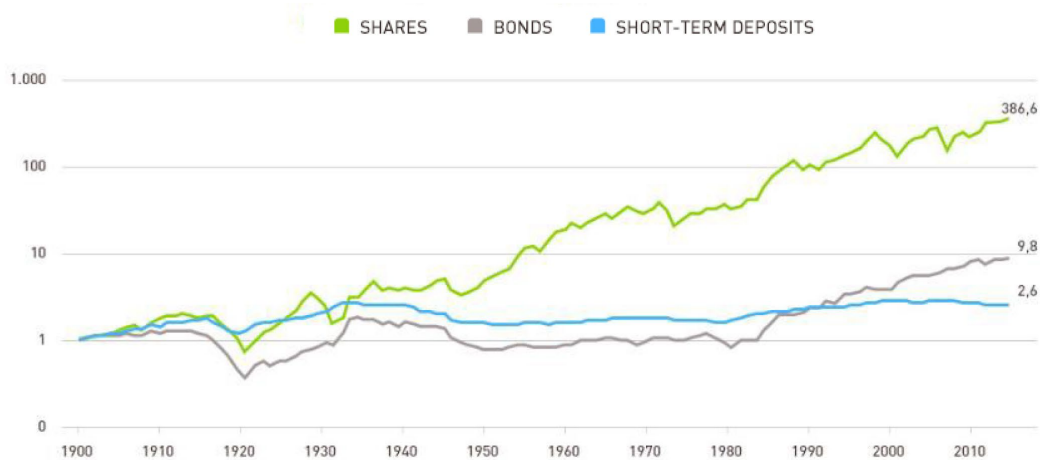


Figure 3 –FED fund rates (in green) compared to US inflation/CPI (in red) – Source: Bloomberg

As an investor, you probably ask yourself what to do given this rapidly changing environment. The first thing to keep in mind is that the **current level of interest rates is not at all unusual. The past ten years of zero rates is the abnormality and is unlikely to come back.** As the graph above shows, a 5% yield (in green), while much higher than two years ago, is in line with the long-term average in the United States, with rates hovering around that level over the last seventy years, except for 15 years in the 1970s and early 1980s. The other factor to keep in mind is **that the massive reduction in interest rates between 1982 and 2020 is highly unusual** (green arrow down on the graph above). It created a golden period of investment where most asset prices went up. A much more normal situation is the situation described by the graph below, where fixed income (in grey) rarely generates any returns, cash deposits (in blue) can be an interesting tool to manage short term liquidity, but will not make you rich, and the only way to generate positive returns,¹ especially after inflation, is to be a long-term investor in the stock market.



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Figure 4 –Cumulative real returns of different asset classes 1900-2017 – Source: Credit Suisse Global Investment Returns Yearbook 2018, Elroy Dimson, Paul Marsh, and Mike Staunton, *Triumph of the Optimists: 101 Years of Global Investment Returns*, Princeton University Press 2002

Past market behaviours do not prejudice future behaviours.

After inflation, the global stock market generated an annual return of 5.2% per year between 1900 and 2018, cash had a return of 0.8% and fixed income of 2%. 2% might seem fine to conservative investors, but it hides the fact that all that return was generated between 1980 and 2018. Fixed income generated no returns between 1900 and 1980 after inflation! We also caution investors about other asset classes which benefitted tremendously from the drop in interest rates over the last three decades. Leverage buyouts, a type of private equity investment where a lot of debt is raised

¹ No guarantee of results or performance

to buy a company, work very well when the cost of debt was in the single digits and going down. It is going to be a lot harder to pull off the amazing past returns when the cost of debt is above 10% and rising. In general, investors should be very cautious about any investment which has the words 'leverage' or 'debt' in it. Not every opportunity will be bad but significant caution is required.

In these changing times, our investment and commercial teams continue to be available for any eventual questions. Feel free to get in touch by email and by phone.

Our convictions

Since we started offering financial products to Belgian investors in the early 2000's, we have always been on the lookout for new strategies to better serve our clients. Our firm's history started with convertible bonds, which continue to be an interesting asset class, to have exposure to entrepreneurial, fast-growing businesses without too much volatility. In 2006, we started offering **global active equity funds** and then, with the help of Amundi, a **global equity passive fund** in 2015. Finally in 2021, we launched our first **quantitative strategy** with the "Dogs of the Dow", followed by the S&P 500 Buyback FCF in 2023, both offered through a Belgian Institutional fund. Each strategy has its advantages and its drawbacks, so we always recommend speaking to a financial advisor first to understand your risk tolerance, and we generally advise a mix of the different strategies.

A **global equity passive fund** gives you exposure to the whole world equity market with positions in nearly every sector, across both developed countries and major emerging markets. This product is market cap weighted, meaning big companies by valuation have a bigger weight. The largest positions in this strategy are therefore US tech companies, mainly **Microsoft, Apple, Meta (ex-Facebook), Tesla, NVIDIA, Alphabet (ex-Google) and Amazon²**, or the so-called 'Magnificent Seven', a more recent nickname invented by analysts to replace the FAANG acronym, which didn't include Tesla and NVIDIA. In recent years, these companies, due to their excellent strategy and business models, have become extremely valuable, with market capitalizations exceeding the GDPs of most countries, and are now so big that they move indices. The American stock market this year would very likely be in negative territory barring the great performance of these stocks. We don't have any opinion on the valuation of these companies - they are over-covered by analysts but nearly no one predicted their bad performance last year and their outstanding recovery in 2023. For all these reasons, an investor should not be over-exposed to these companies, but owning them as well as other great companies like **LVMH, Starbucks, and Toyota**, through a global index makes sense to us. At TreeTop, we don't pretend to have any views on these very large companies and so we offer **the most cost-efficient way** to own them through a passive product.

The other way to manage a portfolio of stocks is to use an **active fund management strategy**, which is run by one manager or an investment team. These types of strategies were the first ones to be implemented when the mutual fund industry started to emerge in the US after the second world war. They offer better diversification than single stock picking and generally better performance, as they are run by professionals. These strategies are supposed to outperform the indices but unfortunately most of them don't over the long term. At TreeTop, we think there is room for these investment strategies, if they are highly differentiated from the index and are run by experienced managers, with a strong investment approach. When well-run, an active strategy will find under-covered, undervalued corners of the market and can offer some excellent un-correlated returns¹ to the global indexes. We have had some successes but also some disappointments here, so we would caution about investing everything in just one active strategy.

Lastly at TreeTop, we have decided to offer **quantitative/systematic** global investment strategies since 2021. Becoming somewhat uncomfortable over the last four years with the increasing valuation levels of American growth companies, we started looking for alternatives. Our first foray into this world was through the **Dogs of the Dow** strategy, which consists of investing in the high dividend yielding members of the Dow Jones. This strategy generally overweighs the 'unloved' stocks of the Dow Jones ('the dogs'), has a decent long-term track-record and played its

² Although for now, the strategy does not include Apple, Meta and Amazon, contrary to the MSCI ACWI index

diversification role very well in 2022. The strategy is not the most sophisticated, is very concentrated and overlooks most members of global equity markets. In general, key advantages of **systematic/quantitative** strategies are their speed, their ability to process massive amounts of data and the absence of cognitive bias, but one downside is that they only rely on past numerical data and have no notion of risks. By relying only on past financial and operational data, most quantitative strategies tend to perform for a limited amount of time and generally suffer from the ‘back-testing’ fallacy, where the computer optimises the portfolio according to past successful factors. Conscious of this problem, we have continued to look for better alternatives and believe we found one with the **S&P500 Buyback Free Cash Flow** strategy. This long name hides the use of several quantitative factors (refer to our last newsletter for more details), mainly related to free cash flow, valuation, and size but also **one discretionary factor, large share buybacks**. Share buybacks are done at the discretion of a company’s management team and are generally done when confidence in the prospects of the business is high. A management team will very rarely do a share buyback if they feel that the future is precarious, and adding this factor in an investment strategy will therefore add a ‘forward looking determinant’. This strategy has significantly outperformed the US stock market over the long run, barely went down in 2022 and we think has a good probability of continuing to outperform,¹ and certainly to provide good diversification. In general, despite the advances of artificial intelligence, human contact and monitoring remains important in the investment world, as computers don’t have the ability yet to fully grasp the complexities of the modern world. Always feel free to get in touch with a real human if you have questions about the economic environment or the different investment strategies.

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