

# Perspectives

## Financial markets analysis

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- Despite the current resilience of the global economy, a recession seems inevitable.
- Having hit record levels in 2022, inflation is set to slow this year.
- The central banks' monetary tightening cycle appears to be entering its final phase.

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### Financial markets 9

- Equity markets should be affected by two trends in 2023, the gradual end of rising rates and the possibility of a sharp economic slowdown.
- A recession scenario is not currently priced into equity markets.
- Asian markets should outperform in 2023.

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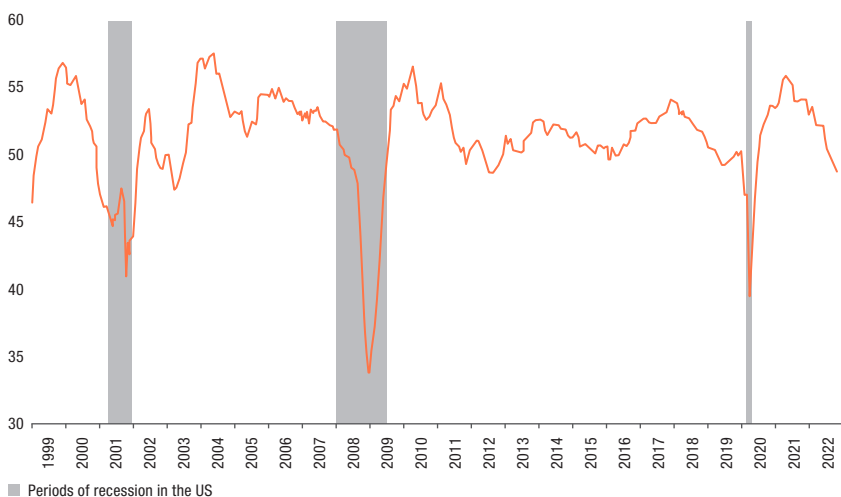
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publication



# Macroeconomic environment

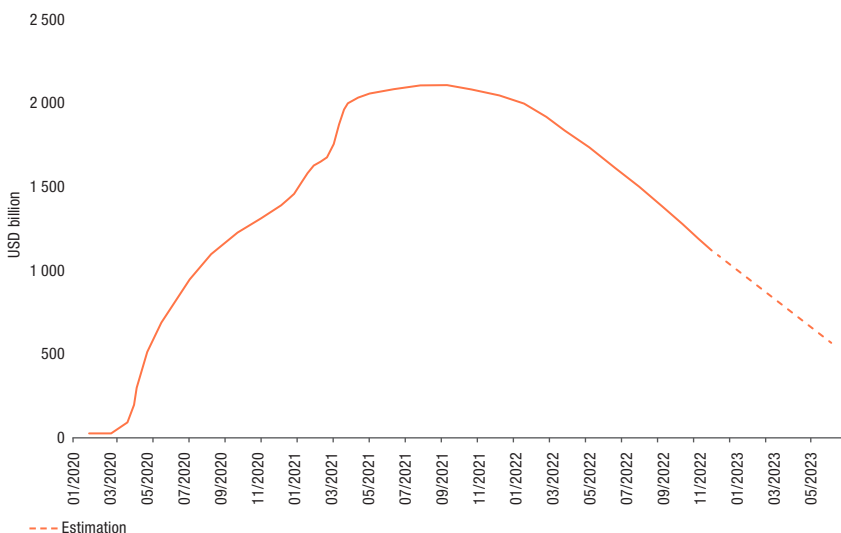
## GLOBAL MANUFACTURING PMI



Source: Piper Sandler

After booming growth in 2021, the global economy was faced with multiple headwinds leading to a marked slowdown in activity in 2022. Household purchasing power was significantly reduced with the ending of the exceptional public support measures implemented during the pandemic and the sharp rise in inflation exacerbated by Russia's invasion of Ukraine. This was compounded by the central banks' monetary tightening causing a severe deterioration in credit conditions for both businesses and individuals. In addition, the slowdown of the Chinese economy due to the persistent weakness of the real estate sector and, until recently, the country's zero-Covid policy, also weighed on global economic growth. The main factor supporting the global economy was the gradual end of lockdown measures in almost all countries (except China) triggering a boom in demand for services, which partially offset the weakness in manufacturing activities. With the tightest monetary policy since the early 1980s and high levels of debt, the economic slowdown is expected to become more widespread in 2023 and eventually lead to a recession.

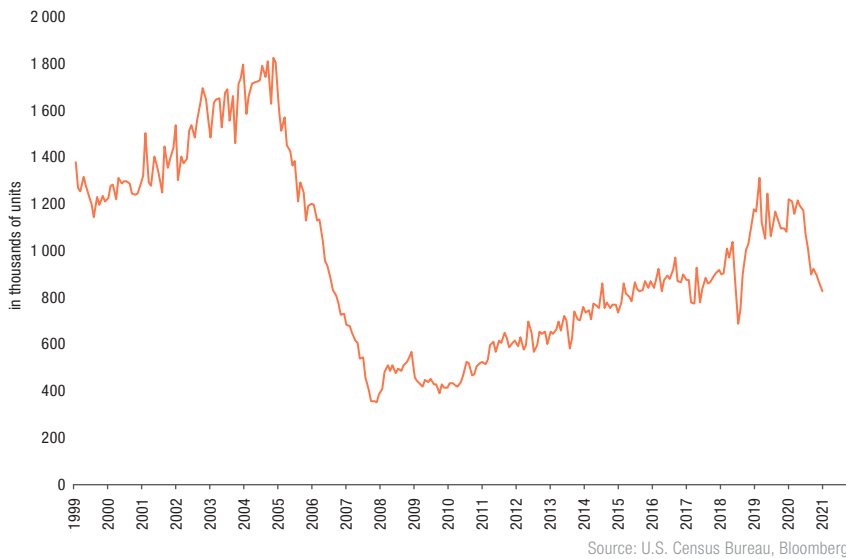
## EXCESS SAVINGS IN THE US



Source: Haver Analytics, Jefferies

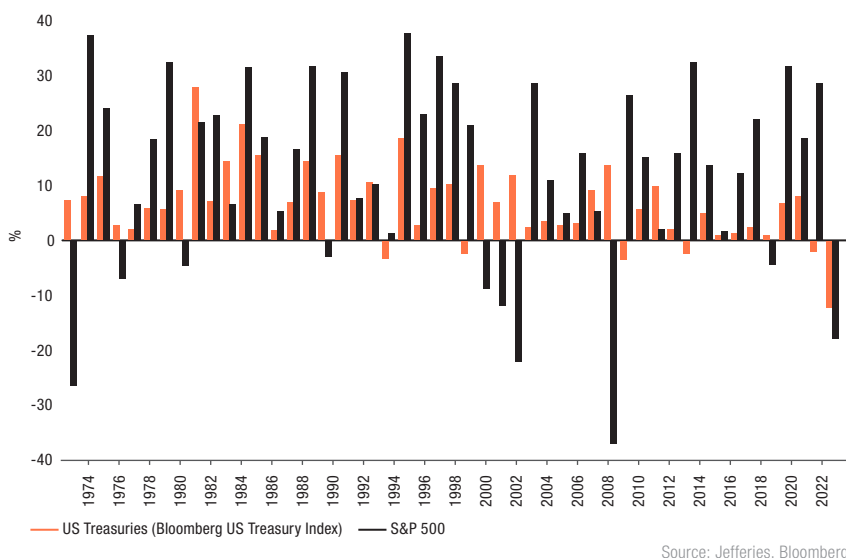
Although the US economy is slowing, it is proving remarkably resilient, so far preventing a major collapse in activity. Households are continuing to draw on their financial reserves, even though excess savings have halved since their peak during the pandemic. Domestic consumption is also benefiting from a buoyant labour market, with job losses in sectors that had fared well during Covid being offset by the creation of new jobs in services activities that are still catching up. At the same time, wage growth remains well above pre-pandemic levels, despite recent signs of moderation. Corporate revenues and profits are continuing to rise as price increases have so far been able to offset rising costs. As a result, investment remains at a high level, constituting one of the main pillars of the post-Covid economic recovery.

## US SINGLE-FAMILY HOUSING STARTS



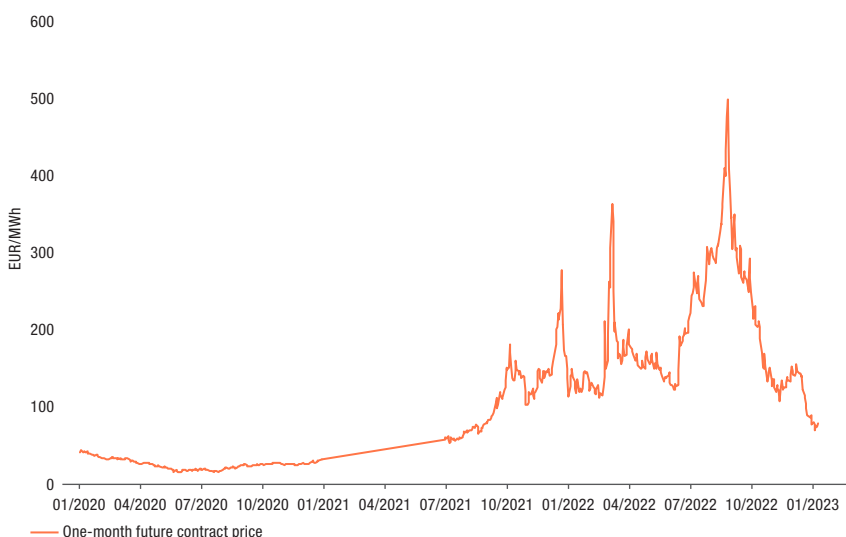
Despite the resilience in activity, a recession this year appears inevitable. The US economy seems to be following the traditional path of a slowdown cycle triggered by the Federal Reserve's monetary tightening. Weakness initially appears in the construction sector as it is the first to react to a rise in interest rates, then orders start to falter in the manufacturing sector. The ensuing economic slowdown puts pressure on corporate profits and companies begin to lay off workers, causing the labour market to deteriorate. This is when recession usually starts, caused by the decline in private consumption given that it accounts for nearly 70% of US GDP. Historically, the gap between the first interest rate hike and its impact on the level of consumption is 12 to 18 months. Since the first increase in the federal funds rate was in March 2022, household consumption is expected to start to weaken more significantly in mid-2023. Based on this timeline, economic activity could still escape recession in the first half of the year before contracting in the second half.

## S&P 500 AND US TREASURIES ANNUAL TOTAL RETURN



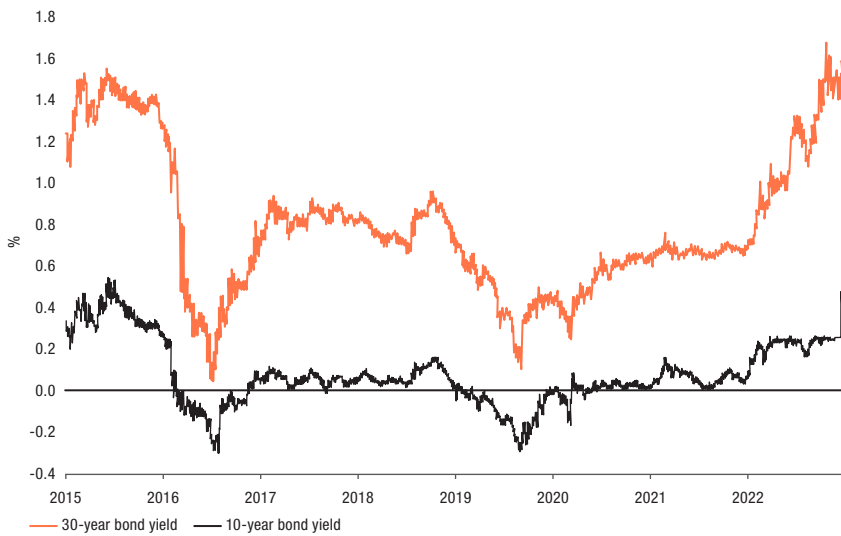
In the past, an economic slowdown caused by monetary tightening has often been linked with a financial shock, exacerbating cyclical weakness and accelerating the onset of recession. Although trying to predict the exact nature of a potential financial shock is a futile exercise, the simultaneous decline in equity and bond markets in 2022, which is very rare and has not happened since 1969, is likely to have created sizeable financial holes in the balance sheets of many financial sector players, such as pension funds and insurance companies. The collapse of the second-largest cryptocurrency trading platform, FTX, offers a foretaste of the potential risks when there is a sharp fall in the prices of the underlying assets. Given the possibility of a financial shock following the drastic monetary tightening of recent months, central banks and governments are likely to have a contingency plan to tackle excessive economic and financial turmoil. Beyond the return of quantitative easing, the introduction of a universal basic income distributed in digital form could become an option in the event of a systemic financial crisis.

## PRICE OF GAS IN GERMANY



The economic resilience seen in the US in recent months is also evident on the European continent, with growth in household consumption offsetting the slowdown in manufacturing activity. The combination of the labour market showing no signs of weakening and government support for the energy crisis is keeping household spending at a high level. Also, with fears of a gas shortage dissipating due to considerable stocks thanks to a mild winter in Europe, the price of gas has fallen sharply to levels well below those reached at the time of Russia's invasion of Ukraine. Nevertheless, the current slowdown in the European economy is likely, as in the United States, to end in recession, given that rising inflation, rising interest rates, a weaker housing market and the first downward revisions of corporate profits are global factors simultaneously affecting economies on both sides of the Atlantic.

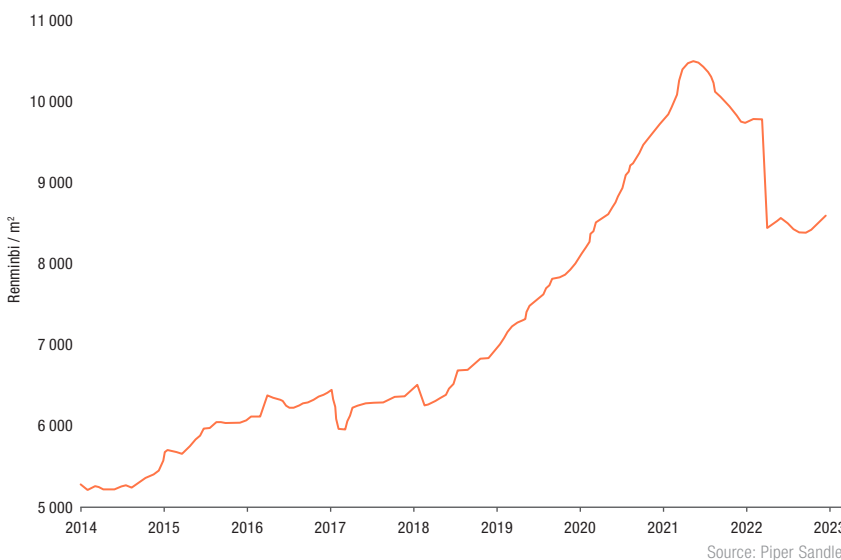
### LONG-TERM GOVERNMENT BOND YIELDS IN JAPAN



Source: Jefferies, Bloomberg

In Japan, economic activity is evolving in line with expectations. The decline in GDP in the third quarter was due more to technical factors than to a deterioration in underlying activity. Domestic consumption is continuing its post-Covid recovery at a moderate pace and exports, supported by the weak yen, remain the most dynamic component of GDP. The main recent change was the Bank of Japan's decision to adjust the upper limit of the 10-year interest rate from 0.25% to 0.50% as part of its yield curve control. According to BoJ Governor Kuroda, this move was not the beginning of a tightening cycle but resulted from the need to remedy the dysfunction observed in the government bond market. The rise in inflation to 3%, the highest level since 1989, and the widening gap between the 30-year yield (which is not set by the Bank of Japan) and the capped 10-year yield made it necessary to adjust the monetary authorities' intervention strategy. Should inflationary pressures persist and the 30-year yield rise further, Kuroda's successor (whose term begins in April) may have to take additional measures and reduce the still very expansive nature of Japanese monetary policy.

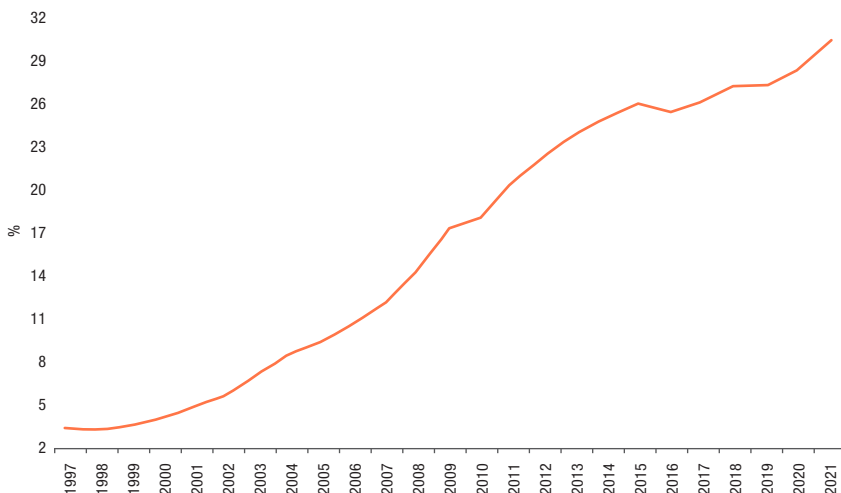
### EXISTING-HOME PRICES IN CHINA



Source: Piper Sandler

In China, the government initiated corrective measures in the fourth quarter to boost flagging economic growth. Crucially, the Beijing government abandoned its zero-Covid policy after nearly three years of strict lockdown measures. Although this U-turn is causing a sharp increase in coronavirus infections – and hence a sharp slowdown in activity in the short term – the gradual normalisation of the health situation should lead to a cyclical improvement from the second quarter at the latest. The government has also announced a series of financial measures to support property developers in a bid to revive the construction sector. However, stimulating real estate activity remains a major challenge as, despite their significant decline in 2022, housing prices are still high even exceeding those prevailing in the US before the 2008 housing crisis in terms of the house-price-to-income ratio. While the characteristics of the Chinese and US economies are too different to compare their respective housing markets, unaffordable prices could prove too great an obstacle to a meaningful recovery in China's real estate sector.

### CHINA'S SHARE OF GLOBAL MANUFACTURING OUTPUT



Source: Jefferies, World Bank, United Nations

Last October, the US government introduced new restrictive measures aimed at denying China access to the most advanced semiconductors and the equipment used to manufacture them. These restrictions represent a further escalation in the geopolitical conflict between the two leading economic and military powers. Since China joined the World Trade Organisation, its share of global manufacturing output has steadily increased, from 5% in 2001 to 30% in 2021. In the coming years, this trend is expected to reverse. Geopolitical tensions have led western governments to encourage their companies to repatriate their production lines. This is increasing the pressure on the Chinese authorities to accelerate the transition from a 'factory of the world' economy to one dominated by services. In these circumstances, restoring consumer confidence, after nearly three years of lockdown and a year of falling property prices, has become essential for fear of missing economic growth targets.

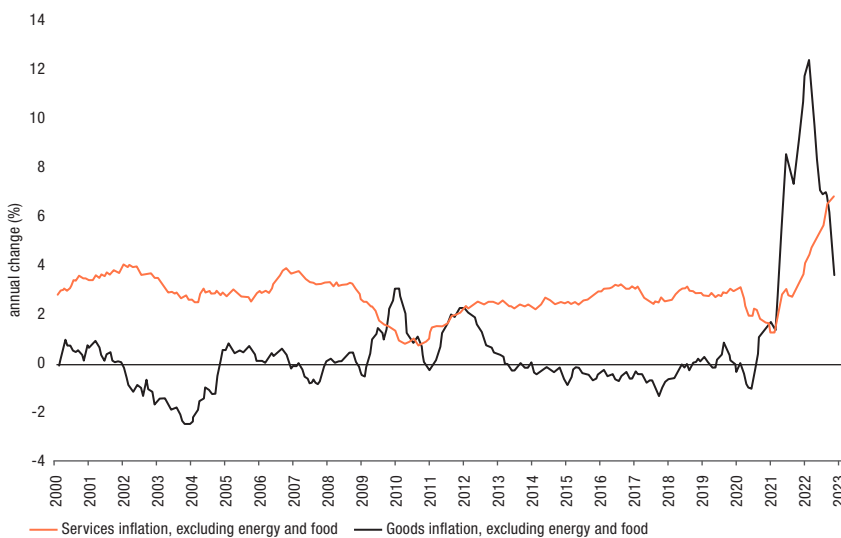
## COST OF SHIPPING



Source: Evercore ISI

After record levels of inflation in 2022, price pressures are expected to gradually ease this year. The first promising factor for a slowdown in inflation is the trend in commodity prices. With commodity prices having risen sharply as a result of the post-Covid economic boom and the Russian invasion of Ukraine, their comparison bases have become so high that even the status quo at current levels would mean a marked year-on-year decline. This is true for most commodities, whether oil, metals or food. A second inflation-limiting factor is the considerable improvement in delivery times as supply chain disruptions have largely been resolved. The global container freight rate index, which measures the cost of shipping, has fallen by 80% since its peak in late 2021, suggesting the near-normalisation of trade flows.

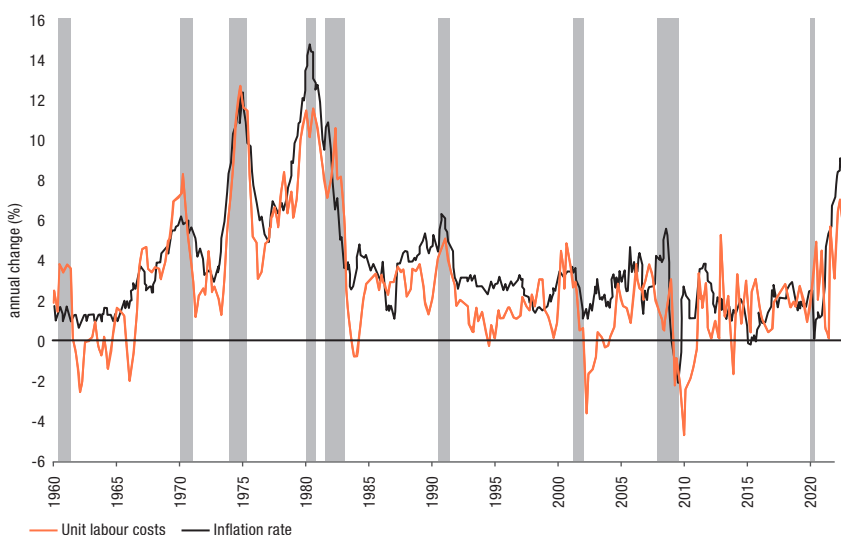
## US INFLATION



Source: Jefferies, Haver Analytics

In the US, inflation came to 6.5% in December, recording its sixth successive month of easing after peaking at 9.1% in June. The current decline in inflation is due to moderating goods prices while prices for services are continuing to accelerate. This divergence is not surprising, given that the pandemic had led to overconsumption of goods at the expense of services, creating a gap between the pace of change in the two categories. On the other hand, inflation in services could prove to be much more persistent than in goods, due to the heavy weighting of the ever-rising rent component, as well as the historically close link between wage trends and services price movements. With services (excluding energy and food) accounting for 57% of the headline inflation rate against only 21% for goods, the potential tenacity of services inflation could prevent a rapid easing in the headline inflation rate towards the Federal Reserve's 2% target.

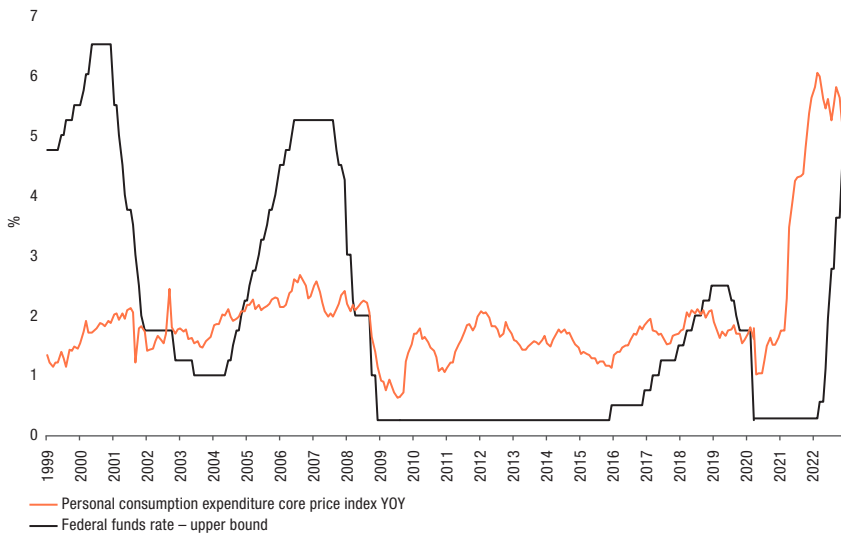
## LABOUR COSTS AND INFLATION IN THE UNITED STATES



Source: Jefferies, Haver Analytics

While a slowdown in inflation during the year seems virtually assured, it is hard to estimate its final level or how far it will deviate from the 2% target. Past periods of high inflation suggest that wage moderation is generally the determining factor in restoring price stability. When last published, employment costs for the third quarter of 2022 increased by 5%, which is not consistent with a 2% inflation target. Unit labour costs (the ratio of total employee compensation to units produced), which are even more closely correlated with inflation, are also continuing to rise too fast. Although the labour market is likely to start deteriorating soon, as yet it is showing few signs of weakness. Enough jobs are still being created to offset the growing number of job losses, keeping the unemployment rate at its lowest level since the early 1970s. The level of inflation at the end of the year will ultimately depend on what happens in the labour market. How far it deteriorates remains too uncertain to be accurately anticipated.

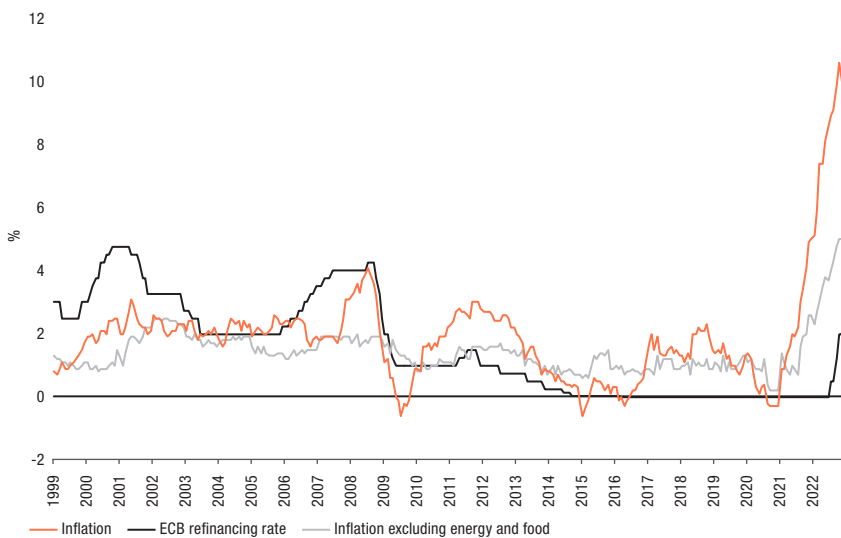
**US MONETARY POLICY**



Source: Bloomberg, Federal Reserve, Bureau of Economic Analysis

The US Federal Reserve appears to be entering its final phase of monetary tightening. Between March and December 2022, the Fed's monetary policy committee increased the upper bound of the target range for the federal funds rate from an initial level of 0.25% to 4.5%, the biggest rate hike since the early 1980s. The market is currently expecting the final level of the federal funds rate to be around 5%, corresponding to two additional 25 basis point hikes in the first half of this year. A rise of this amount would mean real interest rates returning to positive territory during the year. This scenario is only realistic if monetary tightening does not trigger a financial crisis in the meantime, knowing that historically such a crisis has occurred almost every time interest rates have been raised so drastically. Although there are many potential sources of crisis following the central banks' massive injections of liquidity in recent years, the financial markets have become too complex to predict which domino will be the first to fall. If a financial crisis were to erupt, a rapid return to a zero-interest rate policy and quantitative easing would be almost inevitable.

**EUROZONE MONETARY POLICY**



Source: Bloomberg, ECB, Eurostat

In the second half of 2022, the ECB raised its key interest rates by 250 basis points, taking its deposit facility rate to 2% and refinancing rate to 2.5%. At the last meeting of the Governing Council in December, ECB president Christine Lagarde struck a particularly hawkish tone, suggesting continued hikes in 0.5% increments and announcing the start of quantitative tightening from March. Her words reflect the European monetary authorities' aim to show their determination in the fight against inflation, with interest rates remaining substantially negative in real terms. The market currently estimates that the ECB deposit rate will end up at around 3.25%, which would correspond to a further tightening of 125 basis points. However, such a big interest rate hike looks ambitious, given the likelihood of mounting signs of recession in the first half of the year and the growing risk of fragmentation in the eurozone government bond market.





# Financial markets

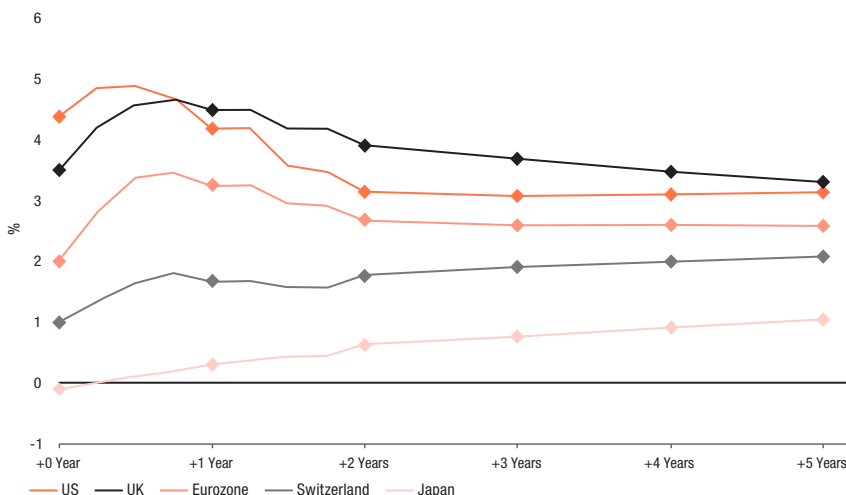
## EVOLUTION OF THE US EQUITY AND LONG-TERM BOND MARKETS SINCE THE END OF 2021



Source: Bloomberg

A much higher than expected rise in interest rates meant that 2022 was not a good year for financial markets. The global equity index fell 18% in dollar terms and 13% in euro terms (including dividends). Helped by the weakness of the euro, the European markets held up better than the US market. The British market even managed to end the year in positive territory. However, rising bond yields weighed heavily on technology stocks, which explains the 33% drop in the Nasdaq index in the US. In a rare occurrence, the bond markets fell together with the stock markets, something that has not happened since 1969 (and before that 1931). Their decline was even greater than that of the stock markets. The poor performance of the bond markets is explained by the rise in inflation, the more aggressive than expected monetary tightening by central banks and, above all, the very low level that bond yields had reached by the end of 2021.

## EXPECTATIONS FOR CHANGES IN CENTRAL BANK POLICY RATES



Source: Bloomberg, JP Morgan Asset Management

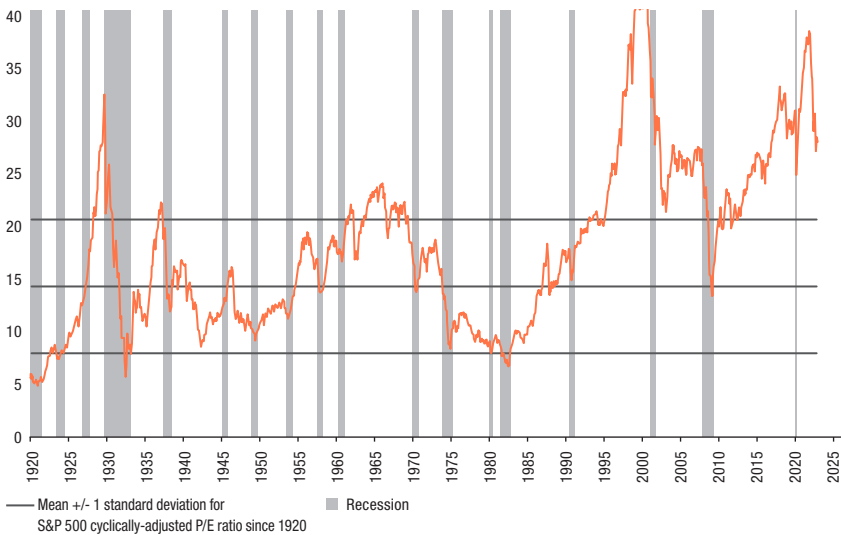
Equity markets could be affected by two trends in 2023, one positive and one negative. On the positive side, central bank monetary tightening and rising bond yields should gradually come to an end or even reverse. On the negative side, the global economy is likely to enter a recession, which would lead to a decrease in corporate profits. If this were to happen, stock prices would fall again. While last year's decline was mainly due to a contraction of valuation multiples as a result of rising interest rates, this year's decline would be due to falling earnings. The optimistic scenario for the stock markets, on the other hand, is based on the idea that the U.S. economy can achieve a soft landing and avoid recession. Historically, however, such soft landings have been the exception rather than the rule, especially after such aggressive monetary tightening as that currently being undertaken by the Federal Reserve.

**ARK INNOVATION INDEX FUND**



In this environment, an investment in stocks should be limited to quality companies. In a context of shrinking liquidity, the era of speculative companies, offering a concept but no profits, seems to be over, as illustrated by the 80% drop in the ARK Innovation fund in the United States, which is mostly invested in unprofitable technology companies, and which has enjoyed massive capital inflows over the past few years. The focus should be on companies that are not very sensitive to economic conditions and that show great resilience in terms of results. History shows for example that a defensive sector such as consumer staples continues to outperform until the purchasing managers' index bottoms out. These defensive companies should also be able to maintain or even increase their dividends, thus providing additional protection.

**CYCLE ADJUSTED PRICE/EARNINGS RATIO**



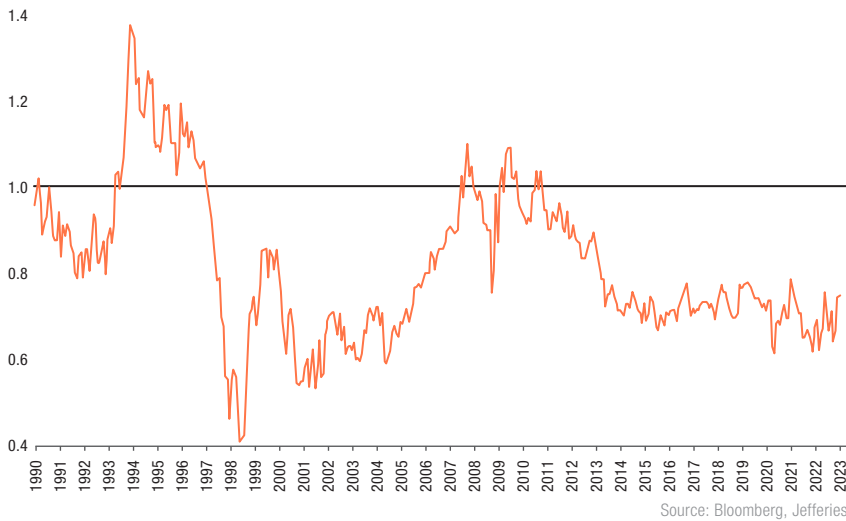
Notwithstanding the sharp decline in multiples, stock market valuations remain relatively stretched. This is especially true since earnings expectations remain high and do not take into account the risk of a recession. In many sectors, profit margins are also close to their historical highs. The US market remains the most expensive and is trading in an overvalued currency. At the other end of the spectrum, the Asian markets are cheaper and their currencies appear to be undervalued on the whole. Between the two is the European market. For the latter, there is on the one hand the argument that its valuation multiple is relatively low, but on the other hand the reality that quality European companies are often as expensive as their American counterparts, if not more so. In other words, Europe's apparent low valuation is primarily due to the fact that within the indices, sectors such as banking, energy, telecommunications, automotive or utilities are highly weighted. However, the earnings of these sectors are generally much more volatile and should therefore be valued at lower multiples.

**SHARE OF THE 6 LARGEST TECHNOLOGY STOCKS IN THE S&P 500 INDEX**



The broad outperformance of the U.S. market since the financial crisis is largely explained by the rise of the technology sector. Six stocks in particular have driven the S&P 500 Index in recent years: Meta (Facebook), Amazon, Apple, Netflix, Alphabet (Google) and Microsoft. At the end of 2020, these six stocks accounted for more than 25% of the S&P 500 Index. Since then, their weight has declined somewhat but, at 19%, remains high. The strong performance of these six stocks was due to rising earnings on the one hand, and rising valuation multiples on the other, with the two often going hand in hand. Neither of these two factors seems likely to be repeated. The size that these companies have acquired in the meantime makes it impossible for them to grow as fast as they did in the past. Apple's market capitalization alone is higher than that of the German or Swiss market. As for the valuation multiple of these companies, it should progressively decrease in line with the decrease of their growth potential.

**PRICE/EARNINGS RATIO: MSCI ASIA EX JAPAN INDEX PREMIUM/ DISCOUNT TO MSCI USA INDEX**



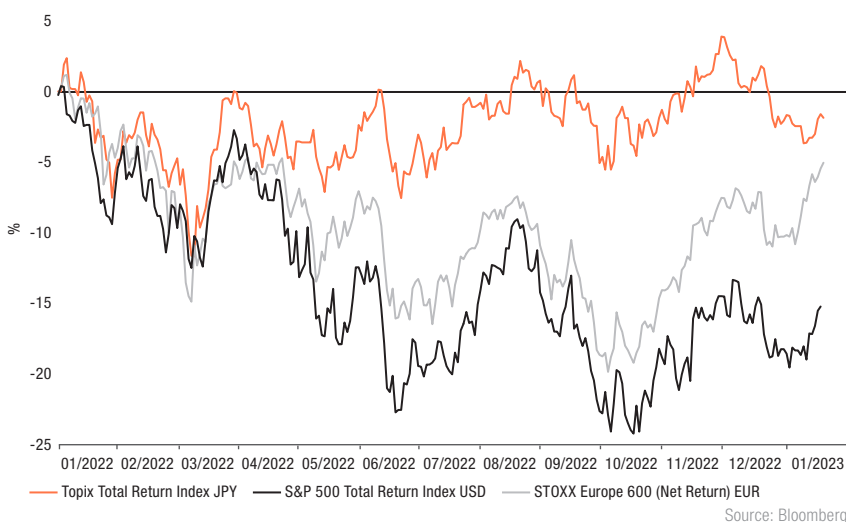
Asian markets have largely underperformed the US market since the financial crisis. In 2022, China's Covid policy and the appreciation of the dollar have again been detrimental. The situation could change in 2023. First of all, the reversal of the Chinese authorities on their "zero-covid" policy and the reopening of the Chinese economy could lead to upward revisions on the earnings of Asian companies, whereas these revisions should be downward for their American counterparts in view of the slowdown of economic activity in the United States. All this at a time when valuation multiples are attractive in Asia, but remain high in the US. Second, the decline in inflation should allow the region's monetary authorities to gradually ease monetary policy. In this respect, it should be noted that inflation in Asian countries has remained well below the levels reached in the West and that real rates are generally in positive territory, which is not the case in Western countries. Finally, a possible weakening of the dollar, in line with the end of monetary tightening in the United States, would provide significant support to the region's markets given their negative correlation with the US currency. It should also be noted that the region's currencies are generally cheap.

**PRICE TO BOOK RATIO OF THE CHINESE MARKET**



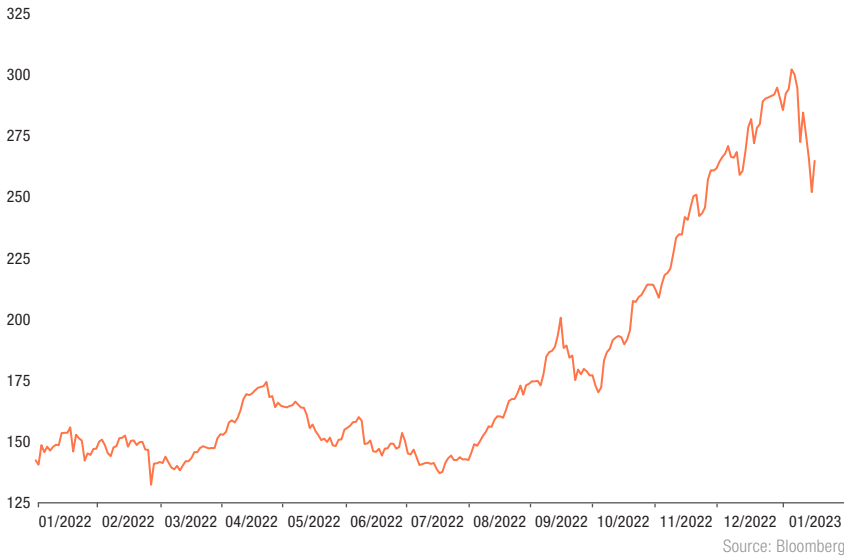
The Chinese market, which accounts for about 25% of the MSCI Asia Pacific ex-Japan index, has started 2023 with a bang. Over the past two years, the Chinese government's crackdown on certain sectors and heightened geopolitical tensions had led to an increase in the risk premium demanded by investors for holding Chinese assets. After the Communist Party Congress in October, this premium reached its highest level in 15 years. This made Chinese assets cheap, setting the stage for the current rebound triggered by the abandonment of the zero-covid health strategy and the reopening of the Chinese economy. As foreign investors are largely absent from this market after their sales of recent years, the rebound in the Chinese market is expected to continue. An investor interested in the Chinese market should be aware, however, that this market operates under different rules than the U.S. market. The political objectives of the Communist Party take precedence over the rights and interests of shareholders. Many companies may therefore be subject to political pressure to align their capital allocation with the Party's strategic objectives, with a negative impact on their profitability. Care should be taken to avoid companies that may be subject to such pressure.

**US, EUROPEAN AND JAPANESE MARKETS SINCE THE END OF 2021 (IN LOCAL CURRENCY)**



The Japanese market has managed to limit the damage in 2022, with the Topix index falling by only 5% in local currency (before dividends). A stabilization or even a rise in the yen's value should encourage foreign investors, who were net sellers in 2022, to return to Japanese stocks. The Japanese market continues to benefit from attractive attributes, including structurally increasing corporate profitability, cash-rich balance sheets, relatively low valuation multiples and a largely undervalued currency. In the medium term, the gradual abandonment of the obsession with deflation and a possible normalization of the yield curve should also prompt local institutional investors to reallocate their assets from bonds to equities. At the same time, an appreciation of the yen would limit their appetite for foreign stocks. As for the companies themselves, they continue to buy back their shares and increase their dividends. Many of them are also benefiting from the undervalued yen.

## TURKISH MARKET EVOLUTION IN USD



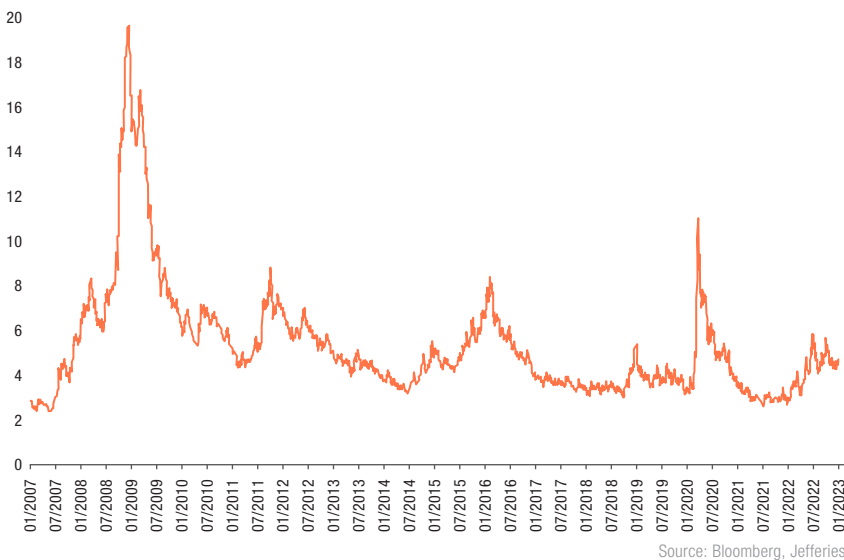
Turkey's stock market was the best performer in 2022, appreciating by more than 100% in USD and EUR terms, despite a nearly 30% depreciation of the Turkish lira against the greenback. This performance was driven by the market's meteoric rise in the second half of the year, after President Erdogan ordered the Central Bank to reverse the tightening of its monetary policy. The monetary authorities began to lower their key rates, despite an inflation rate of over 70%, and the Turkish lira depreciated sharply. The example of the Turkish market, like that of the Argentine market, shows that in an environment of soaring inflation and strongly negative real interest rates, equities, as real assets, can take on a safe haven status, helping investors to protect their purchasing power.

## YIELD ON THE 10-YEAR US GOVERNMENT BOND



Last year was a particularly bad year for bond markets, with a sharp rise in yields leading to a massive fall in prices. However, in an environment of slowing economic growth and falling inflation, government bonds are likely to return to favour in 2023. This conclusion applies primarily to US bonds, while eurozone bonds offer lower yields and idiosyncratic risks, particularly in the event of quantitative tightening by the European Central Bank. After reaching a high of 4.25% at the end of October, the yield on the US 10-year government bond has already fallen back to 3.5%. This yield is expected to end the year at a lower level than today's. Temporary upward pressure will obviously be possible, especially if investors' expectations of rapid monetary easing are disappointed. However, riskier bonds could suffer in the event of a sharp economic downturn, especially as the interest spread between these bonds and government bonds has remained surprisingly low. The rise in default rates has only just begun.

## US HIGH-YIELD CORPORATE BOND SPREAD



While the short-term outlook for the bond markets thus seems favourable, at least for investment grade bonds, this is not the case for the long-term outlook. Firstly, a possible too rapid about-face by central banks (to face an increased risk of recession) would increase the risk of permanently higher inflation. Secondly, the capital needs of governments will remain very high with the financing of social programs, the energy transition, increased defence spending and the need to refinance existing debt and pay interest on it. At the same time, central banks, which have been the main buyers of sovereign debt in recent years, intend to reduce the size of their balance sheets. All this means that government bonds have clearly lost their status as "risk-free" assets. The fact that in 2022 the bond markets lost more than the stock markets illustrates this.

**EVOLUTION OF THE TRADE WEIGHTED EXCHANGE RATE OF THE DOLLAR**



The dollar's appreciation cycle seems to be over. The US currency was supported by the Federal Reserve's faster and more aggressive monetary tightening. It also benefited from its safe haven status in a context of increasing geopolitical risk. In 2023, however, the U.S. central bank could be more accommodating in its monetary policy than its European counterpart. Moreover, the US authorities will not hesitate to encourage a decline in the dollar in the event of a pronounced slowdown in US economic activity. That said, the recent rally in the euro has been rapid and seems to be partly based on expectations of a cut in US policy rates in the second half of this year. These expectations could be disappointed.

**EVOLUTION OF THE YEN AGAINST THE DOLLAR**



The yen could be the main beneficiary of the gradual end to monetary tightening in the West. Among the major central banks, the Bank of Japan was the only one not to tighten. It even maintained its policy of controlling the yield curve, even though it slightly increased its target for the 10-year rate at the end of the year. This monetary policy differential weighed heavily on the yen, which depreciated by 12% against the dollar and 7% against the euro. The depreciation against the dollar had even reached 24% by the end of October, before the Japanese currency began to recover, helped by the expectation of a less restrictive Federal Reserve and the increase in the Bank of Japan's target for the 10-year rate. Assuming that monetary tightening outside of Japan is coming to an end, the Japanese currency could rebound, especially since it appears very undervalued and remains supported by a large current account surplus. The end of Bank of Japan Governor Haruhiko Kuroda's term in March could also introduce a new deal.

**GOLD PRICE EVOLUTION**



While it has not really fulfilled its role as a hedge against inflation (unless one considers that the sharp rise in the gold price between August 2018 and August 2020 anticipated the rise in inflation in 2021/2022), gold has finally weathered the rise in rates and the appreciation of the dollar in 2022 well by ending the year almost unchanged in USD and up 6% in euro. The case for gold is strengthening. First of all, the rise in real rates (nominal rates minus inflationary expectations) observed last year seems to be coming to an end. The same is true for the dollar's appreciation cycle. Secondly, central banks continue to make massive purchases. Finally, there is a certain disillusionment with crypto-currencies, which some people saw as replacing the yellow metal as a safe haven against fiat currencies. In a context where the United States is increasingly using the dollar as a geopolitical weapon, gold also offers a particular attraction for many countries. An investor able to assume their volatility will be interested in gold companies that amplify the movements of the gold price.

# Summary

In summary, a defensive stance should be taken while waiting to see what last year's impact monetary tightening and rising interest rates will have on corporate demand and earnings.

In general, a possible sharp slowdown in economic conditions is not currently priced into stock prices. Expectations for corporate earnings growth remain relatively high. History shows that if the stock market partially anticipates a recession, stock prices only bottom out a few months after the recession has begun. During those few months, stock prices fall as earnings estimates are revised downward. The context is more favourable for Asian markets, which will benefit from gradually less aggressive central banks and the reopening of China. At the bond level, it is important to stay in quality bonds, especially since the spread offered by lower quality bonds remains surprisingly low. For non-investment grade debt, the dominant theme may be increasing bankruptcies, rather than an end to monetary tightening.

A return to the environment that characterized the post-financial crisis years of moderate growth, contained inflation and very accommodative financial conditions seems unrealistic. Inflation is expected to fall in 2023. In the longer term, however, the global economy seems to have entered a period in which the risk of inflation will be two-way. If they want to avoid a de-escalation of inflationary expectations, central banks will not be able to revert to the monetary policies of the last few years.

The last few decades have been very favourable for financial markets. Falling inflation rates have pushed down interest rates, while the end of the Cold War has lowered the risk premium demanded by investors. Globalization and economic liberalism reduced the bargaining power of workers in the developed world while simultaneously increasing corporate profitability. All of these positive trends have resulted in an re-rating of financial assets.

Some or all of these positive trends may slowly turn around. The result will be a decrease in investor risk appetite and a deterioration in corporate profitability. Investors should therefore expect much weaker returns in the years to come. In addition, a significant increase in volatility is to be expected.

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