Our View in July

12 July 2022

VP BANK

New problems almost by the day

Inflation remains high and economic sentiment is already rock bottom. As if that were not enough, new problems for the economy seem to be emerging constantly. We reduce risk again by lowering the equity allocation.

Have you ever played "Whack a mole" at a fun fair? You can hardly keep up with hitting the figures that randomly appear from the holes in the table. It is definitely stressful and sometimes frustrating.

That's how it feels at the moment when you look at the economy and the financial markets. New problems crop up all the time. First there was a shortage of goods, now of staff. And the latter does not only affect airline passengers who have to wait for hours at the security check.

Concerns about an energy crisis in Europe have been smouldering for some time. The gas storage facilities are still well filled, but that may change quickly. In any case, gas prices once again know only one direction: upwards. This means that the all-clear cannot yet be given for inflation either. So the central banks are not running out of work. Because one thing is clear: the measures taken so far are not enough.

The stock markets have already suffered a lot in recent months. There is no longer any talk of exaggerated valuations. Conversely, equities are not yet cheap.

If the economy enters a recession, and there are increasing signs for this to happen, then corporate profits will come under pressure more than analysts currently expect.

Therefore, the Investment Committee has decided to reduce the equity exposure once more. We are achieving this by closing the overweight in Japan. The Japanese stock market has outperformed the US and Europe since March. However, Japanese equities are not immune to a global recession

Dr Felix Brill, **Chief Investment Officer**

Our View on the **Portfolio**

- **Defensive** portfolio
- **Diversification** pays off
- Good prospects for **insurance-linked securities (ILS)**

- **Economic downturn** weighs on outlook for corporate profits
- No all-clear on **inflation**
- Significant **downside risks**

Money market	● ● ● ● ●
Bonds	● ● ○ ○ ○
• Government Bonds	● ● ○ ○ ○
• Corporate Bonds	● ● ● ○ ○
• USD Bonds	● ● ● ○ ○
• Emerging Markets	● ● ● ○ ○
Equities	● ○ ○ ○ ○
• Switzerland	● ● ● ○ ○
• Europe	● ● ○ ○ ○
• USA	● ● ○ ○ ○
• Japan	● ● ● ○ ○
• Emerging Markets	● ● ● ○ ○
• World and Themes	● ● ● ○ ○
Alternative Assets	● ● ● ● ○
• Hedge funds	● ● ● ○ ○
• ILS	● ● ● ● ○
• Convertible Bonds	● ● ● ○ ○
• Gold	● ● ● ○ ○

● ● ● ● ● strong overweight
● ● ● ○ ○ neutral
● ○ ○ ○ ○ strong underweight

Base: mandate CHF balanced

Our View on the **Economy**

- Major **investment needs**: Governments and the private sector must invest heavily in energy transition and digitisation
- **Consumers** still have some catching-up to do

- Russia could permanently reduce **gas supplies** to Europe
- The Federal Reserve dampens economic growth with its **monetary policy**
- High **energy and food prices** weigh on private consumption

Recession looming

Predicting a recession is a difficult task. But, at the moment, there is hardly any way around a downturn. Rising prices reduce consumers' purchasing power. Companies continue to suffer from material shortages. At the same time, uncertainty is so high that investment sentiment suffers. If consumers and businesses exercise restraint at the same time, a recession is pretty much a foregone conclusion. Moreover, permanently reduced gas supplies from Russia pose a risk not only for Europe, but ultimately for the entire global economy. There would have to be a great deal of positives in order to avoid an economic contraction. Yet, a recession could be the cleansing thunderstorm that restores the balance between supply and demand. This would bring inflation back on a declining path.

Our View on **Monetary Policy**

- The **Fed** pursues the outlined monetary-policy course
- The **SNB** surprises with an unexpectedly sharp hike of 50 basis points and earns confidence

- The **ECB** risks credibility because it is addressing the inflation issue more slowly
- Monetary policy is currently a **balancing act** between a significantly increased risk of recession and high inflation

Markets are pricing rate cuts after the hikes

Interest rate expectations have recently moved sharply. Markets continue to expect the Fed to raise key interest rates vigorously. In the futures markets for short-term lending, though, prices signal lower rates as early as next year. The thinking behind this: A recession will force the Fed to partially reverse its rate hikes. The biggest danger, in our view, is that inflation rates will indeed remain high despite a beginning recession, and that the Fed would choose to favour economic growth over fighting inflation. In the long run, however, a permanently high inflation would entail significant economic costs.

Our View on **Government Bonds**

underweight

- **Economic uncertainty** leads to lower yields
- **Monetary tightening** is largely reflected in government bond prices, limiting the potential for significant further losses

- The **Fed reduces securities holdings** thus taking away support for government bonds
- The **ECB** also stops net purchases of government bonds and **launches interest rate hikes** as of July

Yield consolidation

Long-term interest rates do not only rise, but can also fall at a rapid pace, as they have done recently. Increasing worries about the economy raise doubts about the Fed's stance. Financial markets expect interest rates cuts next year. The yields on the long end of the interest rate curve pre-empt this development. A decline in yields was also expected from a market point of view. Government bonds were oversold, which suggested a correction. But this also shows that, at yield levels of above 3% on the 10-year US Treasury, the air is thin. Probably, the peak in yields is already behind us.

Our View on **Corporate Bonds**

neutral

- Higher **yields** after big losses but not a straightforward buy yet

- Credit spreads still reflect **rising recession risks insufficiently**
- Longer **maturities** and more **leverage** are additional risk factors
- **Higher refinancing costs** burden future corporate profits

Historical losses but not attractive

Losses on corporate bonds are greater than during the 2007-8 financial crisis. Back then, after the collapse of the investment bank Bear Stearns, the financial system was on the verge of collapse. But there's a big difference. At the time, credit spreads in the investment-grade segment increased from 1% to 6%. So far this year, the increase was only from 0.9 % to 1.5 %. Rising yields on risk-free bonds (mainly government bonds) are the main source of this move. Central banks fighting inflation, however, is now increasing the risk of a recession, which is putting a lid on government bond yields. By contrast, depending on the type of recession, credit spreads are likely to double from where they are now. So, at the moment, it is priced in that inflation is being brought under control and a recession can be avoided. This may prove too optimistic.

Our View on **Equities**

strong underweight

- Central banks are sending important signals about their view on **inflation**
- **Stimulus plans** in China, Japan, and Europe help to meet the current challenges

- Fears about **Europe's energy supply** cause excessive gas and electricity prices
- **US** fails to deliver key economic stimulus packages

Remain defensively positioned

Rising recession fears have caused a renewed weakness in capital markets, with the US stock market performing better than Europe. While US President Joe Biden's administration is not launching his promised stimulus, the US Federal Reserve can reassure market participants with its policy. This is important as July will be an eventful month: Two major central bank meetings (Fed and ECB), the second-quarter earnings season and the expected resumption of gas supplies from Russia at the end of July will be hotly debated in stock markets. This means that market participants are dealing with crisis management rather than new growth. It is expected that the current consolidation process is not completed yet. It is still recommended to take a defensive position.

Our View on **Japanese Equities**

neutral

- Strong **fiscal and monetary support** from government and central bank
- **Weak yen** supports the export-sensitive Japanese economy

- Japan's expansionary monetary policy raises questions about high **debt** in Japan
- Despite high economic recovery potential in the current fiscal year, average **earnings growth** is low compared to other G7 countries by 2025

Back to neutral

The stock market in Japan has been one of the best regions, with a loss of 7% this year. Japan benefits from continued expansionary monetary policy and from a recovery plan of more than EUR 600 billion ready to be executed. This benefits domestic industry and households alike. A moderate inflation rate (core inflation: 2 %) and a markedly depreciated yen provide additional support. The rotation of global production and supply chains triggered by geo-political tensions is also stimulating. Japan, as a G7 nation, offers international companies a safe alternative in the Asia-Pacific economic area. However, most of this is probably already reflected in the share prices. However, even Japan cannot escape a global downturn.

Our View on **Alternative Investments - ILS**

overweight

- High **Hurricane activity** priced in for the coming months
- If the damage is below expectations, a **strong second half year** can be expected

- If a hurricane were to hit a city like Miami, the asset class **loses**
- **Earthquakes** may occur all year round
- Individual exposures may be triggered by an **accumulation of damages** over several years

Diversification pays

Insurance-linked securities and cat bonds perform independent of economic data, enabling them to beat stock and bond markets. The performance of our recommended products (after fees) in the first half of the year ranged from -0.5% to +0.5%. Such performance is typical in the first half of the year. But the transatlantic hurricane season, which lasts from June to the end of November, is crucial. A slightly above average activity is expected in 2022, comparable to the previous three years. This is also the reason for the increase in spreads (lower overall return) in the first half of the year. If the hurricane damage is lower than expected, this would generate an additional performance opportunity. It remains crucial whether hurricanes make landfall and if so whether this is in the countryside or in a densely populated area. We expect a significant positive contribution in the second half of the year.

Our View on **Currencies**

- **Swiss franc** could strengthen as long as the ECB remains hesitant
- Should Russia cut gas supplies to Europe, the **dollar** would remain a safe haven

- **Russian rouble** remains beaten down
- Japan's central bank remains expansionary, putting the **yen** under strain
- Inflation risks limit the recovery potential of **emerging market** currencies

Franc on parity with the euro

The recent appreciation of the franc is justified. We calculate that the purchasing power parity, based on producer price indices, points to a fair exchange rate level relative to the euro of 0.90. So the franc is even undervalued at the current rate. That is precisely why the Swiss National Bank (SNB) did not shy away from raising the key interest rate earlier than the European Central Bank (ECB) by 50 basis points. The SNB has also changed the wording and considers the Swiss currency to be no longer highly valued. Moreover, Swiss monetary policy makers also reserve the right to reduce their foreign exchange reserves, which would even lead to a further strengthening of the franc (more on this).

Authors and disclaimer

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