Our View in November

8 November 2022

A little bit of everything

The risks for the economy and financial markets remain considerable, no question. Recently, however, there have also been positive signals. Is the glass now empty, half empty or half full? At the moment, the news offers something for everyone.

Let's start with the good news: The supply chain situation is easing, as shown by the VP Bank Supply Chain Index. Secondly, several European countries are limiting the effect of higher energy prices with price caps, which does not prevent recession. But this measure reduces the risk that an economic horror scenario will occur. Thirdly, there are increasing signs that US inflation has peaked and that inflation rates could decline significantly next year.

The latter would be an important prerequisite for the US Federal Reserve not only to proceed more slowly with rate hikes, but also to discontinue them altogether. We are not at that point just yet, as Fed Chairman Jerome Powell made clear at the last media conference in early November. The next interest rate hike is therefore likely to follow in December; a further increase of 50 basis points seems to be on the cards at the moment.

Monetary policy is thus attempting to bridge the gap between inflation rates, which are still far too high, and the risk of recession. For the European Central Bank, this balancing act is even more painful, as the short-term inflationary pressure is much greater than in the US and the economic signals are much worse. If business and consumer sentiment does not improve quickly, a recession is inevitable.

For the Investment Committee, the risks currently weigh too heavy still. Therefore, the underweight in equities is confirmed. Due to the renewed rise in dollar yields, we are upgrading US government bonds in the US dollar mandates to overweight.

Dr Felix Brill, **Chief Investment Officer**

Our View on the **Portfolio**

- **US inflation** could fall faster than expected in the coming months
- **Energy price caps** reduce risk of private and corporate insolvencies in Europe

- **Monetary policy** remains a balancing act between high inflation and recession signals
- **Recession risks** not fully reflected in equity valuations and credit spreads
- **Risk premium** for US equities significantly lower

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

Base: mandate CHF balanced

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

Our View on the **Economy**

- **Energy price** cap reduces risk of private and corporate insolvencies in Europe
- **Service sector** still benefits from catch-up effects

- US Federal Reserve dampens **economic development with rate hikes** and balance sheet reduction
- Rising **energy and food prices** weigh on private consumption

Glimmers of hope

From an economic point of view, there have been rays of hope recently. The supply chains, which had been disrupted for a long time, have improved. Above all, however, the European gas markets have calmed down considerably. And the high energy prices in Europe are being capped by means of a government market intervention. In the US, meanwhile, there are a number of indicators suggesting that the inflation rate may fall significantly in the coming year. This would then be an opportunity for the Fed to stop or pause its rate hike cycle. While these positive aspects come too late to prevent a recession, they still give reason to hope that the trend reversal to yet again positive growth rates will be possible in the course of 2023.

Our View on **Monetary Policy**

- **Fed** to increase Fed Funds Target Rate by 50 basis points in December
- **ECB** will be forced to hike key interest rates by another 75 basis points in December
- **SNB** to lift policy rate by 75 basis points in December

- **Monetary policy** is more than ever a balancing act between recession and high inflation
- Restrictive monetary policy could even increase **inflation in a risk scenario**

Central banks stay committed

The US Federal Reserve raised the key interest rate by 75 basis points in November. However, its chair Jerome Powell now signals a slowing pace of monetary tightening. Due to the significantly tighter monetary policy this year, the risk of a very hard landing for the US economy is increasing. It is therefore understandable that Powell is ratcheting back somewhat and is now holding out the prospect of smaller interest rate steps. At the next policy meeting in December, a rate hike of "only" 50 basis points is likely to be on the agenda. In order not to give the impression of too loose a handling of the inflation trend, Powell also made it clear that the key interest rate will probably be raised above the level that could be seen in the Fed officials' projections. The motto is: slower, but more. The Fed Funds Target Rate high in this cycle is likely to be in the range of 5 % or perhaps even slightly higher.

Our View on **Government Bonds**

- **Economic downturn** supports government bonds and limits potential of a significant rise in yields
- **US inflation rates** could fall more than expected in coming months

- Renewed inflation concerns could **prolong the rise in yields**
- Due to the Fed's selling of securities, government bonds **lose an important support**

From inflation to recession risks

The US economy is still posting solid growth rates in the second half of 2022, but signs are pointing to a recession. If leading economic indicators continue to point downwards and, at the same time, the inflation momentum is slowing noticeably, the current US yield level would be at its peak.

But what about the Eurozone? If the European Central Bank (ECB) were to raise the key interest rates significantly higher due to elevated inflation figures, European yields would be in a kind of dilemma between rising key interest rates and a US yield curve that is no longer moving upwards. In this scenario, yields in the Eurozone would presumably continue to rise - but the increase would likely not be particularly significant due to what is going on in the US.

Our View on **Corporate Bonds**

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neutral

- Higher coupons ensure **lower loss potential in future**
- End of policy rate hikes by central banks will **ease the situation for long term interest rates**

- **Credit spreads likely to rise** significantly in the event of a recession
- Corporate bonds are thus **less attractive** than government bonds

Iceberg ahead

The year to date has been one of the worst in bond performance history. This was because coupons were too low to offset losses and on top credit spreads rose as well. For global investment grade bonds, the year-to-date performance is -20%; 84% of this is due to rising interest rates and 16% to spread widening. For US High Yield, where coupons were able to absorb somewhat, the loss since the beginning of the year comes to 13 % and is 58 % attributable to rising interest rates and less to spreads. From now on, the opposite should be expected. As soon as the central banks get closer to their goal and the interest rate cycle ends, the credit spread is likely to become a burden.

Our View on **Equities**

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underweight

- Electricity and gas price brakes in Europe **support the economy**
- Global supply chain problems **noticeably reduced**
- Attractive fundamental valuations for **promising quality stocks** appearing

- Central banks could **trigger stronger economic downturn**
- USA still fundamentally **highly valued**
- Pre-Christmas sales at risk due to **high inflation**

Highly resistant

Market participants expect the US Federal Reserve's interest rate tightening to come to an end. Similarly, companies are reporting better-than-anticipated third-quarter results. Government interventions in Europe and China supporting the economy are also being welcomed. Although earnings expectations for 2023 are falling, some confidence is returning due to the resilience of companies. Fundamental valuations signal a mild recession in Europe and in emerging markets. The greatest risk of disappointment is in the US market. There, valuations are still hardly pricing in an economic slowdown.

Our View on **Equities Europe**

- Electricity and gas price brakes in Europe **support the economy**
- Solid profit development despite **difficult economic conditions**
- **Attractive fundamental valuation**

- Rising interest rates weigh on **construction sector** and leasing
- Energy costs will remain **significantly higher** in 2023
- **Burden** on pre-**Christmas sales** due to very high energy prices

Zero growth in 2023 is priced in

In the context of the current difficult phase for the stock market, European equities are proving relatively strong. The fundamental valuations are pricing in a mild recession. The efforts of the EU and the respective countries are having a positive effect: energy price caps are already in place in important industrial regions of Europe, and Germany is now following suit. Although energy prices are likely to remain high, this will ease the burden on both private households and industry. At the same time, companies in Europe are offering technological solutions to achieve the climate and environmental goals that have been set. The economic environment should remain tense for some quarters to come and also put pressure on margins. However, the equity market in Europe stands already at a low valuation and zero earnings growth for 2023 is priced in.

Our View on **Alternative Investments - Gold**

- With increased volatility in equities, gold is seen as a **safe haven**
- Geopolitical and economic risks **are supportive**
- Possible end of tightening cycle **would be positive**

- Stronger USD reduces **purchasing power**
- Central banks remain **restrictive**
- Higher bond yields **increase opportunity costs**

Gold loses some of its shine

To the surprise of many investors, gold failed to live up to its reputation as a safe haven during the year despite many crises and risks. Gold competes with US government bonds, however, since it does not yield a return, the opportunity costs increase when interest rates rise. The US dollar also benefits from higher interest rates. Gold is traded in dollars, which is why a strong USD additionally reduces purchasing power and thus demand. Although the precious metal is trading lower year-on-year, the loss has so far been less pronounced than on the bond or equity markets. Due to currency effects, gold has been able to perform better in euros or pounds. In the short term, the pressure is likely to remain, but gold could benefit from an end to the Fed's rate hike cycle and if economic and geopolitical risks persist.

Our View on **Currencies**

- **ECB** recently sharpened its tone in the fight against high inflation rates. The surprise potential lies on the side of the EUR
- The **Swiss Franc** remains in demand as a safe haven

- **Emerging market currencies** remain less attractive due to inflation risks
- The Japanese central bank maintains its expansionary course, which weighs on the **yen**

Is the ECB giving the euro a tailwind?

The euro was able to recover somewhat recently, which confirmed our view of at least a somewhat stronger European common currency. The price gains are based on higher risk appetite on the financial markets and also the easing on the European gas markets. Looking ahead, the decisive factor will now be how the European Central Bank (ECB) will react to the high inflation rates of over 10%. While there are signs that inflationary pressure is easing in the US, there is no all-clear in the Eurozone. Inflation dynamics in the euro area are higher than in the US. If it turns out that the Fed can shift down a gear and the ECB has to do more, the euro should gain. Therefore, we expect higher prices for the euro against the US dollar over the next 3 to 6 months.

Authors and disclaimer

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