Our View in June

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VP BANK

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The eurozone is already in recession, the US will follow. Financial markets continue to dream of a soft landing. But we are not. We continue to prefer bonds and are cautious for equities.

It can happen pretty quickly. Most economists were busy with the outlook for the second half of the year and thus with the question of when and if the recession would start. And then, all of a sudden, the data show: the eurozone is already in a recession, at least according to the understanding of markets. Two quarters of declining GDP in a row are considered a recession.

But that has not bothered stock markets so far. Once again, optimism prevails. Investors rely on hope. Everything is not so bad, so the thinking goes, inflation is falling, the labour market is robust and companies will soon be able to generate more profits again. The recession in the eurozone would therefore only be of a technical nature; the same would apply to the US if a recession were to occur there. The economic landing will be soft.

We do not rely on hope. In our view, the landing will be rather hard and the economy will come under noticeable pressure. We have all the ingredients: a worsening credit crunch, corporate reluctance to invest and a worsening outlook for private consumption. And the first cracks have also appeared in the hitherto shiny facade of the labour market in the US.

In addition, central banks will not be able or willing to support the economy as quickly and as strongly this time. Despite falling inflation rates in the short term, the issue of inflation has not yet been fully digested. You can read more about this in the new issue of our investment magazine Telescope (due to be published on 19 June).

Dr. Felix Brill**, Chief Investment Officer**

Our View on the **Portfolio**

- Inflation is falling in the eurozone and in the US which is good for **government bonds**
- **Japanese equities** are more attractive in terms of valuation than their US counterparts
- Focus on **future trends** instead of just the heavyweights in the US equity market

- **US equity market** lacks market breadth
- **Credit spreads** too low for US hard landing scenario

Money Market	●●●●●
Bonds	●●●●○
• Government Bonds	●●●○○
• Corporate Bonds	●●●○○
• USD Bonds	●●●○○
• Emerging Market Bonds	●●●●○
Equities	●○○○○
• Equities Switzerland	●●○○○
• Equities Europe	●●○○○
• Equities USA	●●○○○
• Equities Japan	●●●○○
• Equities Emerging Markets	●●●○○
• Equities World and Themes	●●●○○
Alternative Investments	●●●○○
• Hedge Funds	●●●○○
• Insurance-linked Securities	●●●○○
• Convertible Bonds	●●●○○
• Gold	●●●○○

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

(Base: Mandate CHF balanced)

Our View on the Economy

- Turnover in the **service sector** is normalising
- **Falling energy prices** support the economy

- **US** likely to slide into recession later in the year as a result of monetary policy
- Global **economic environment** remains difficult

Appearances are deceptive

The global macro data signal weakness. Even China's longed-for economic recovery after the end of the Zero-Covid policy turns out to be much weaker than expected by numerous economists. Industrial production in particular is proving to be almost frighteningly weak. But the data in Europe and the US have not been convincing either. On the other hand, the further fall in energy prices, especially in gas prices, is a positive factor. This is easing the burden on companies and private households. However, we remain sceptical and continue to expect a noticeable economic slowdown. This is because the elevated inflation and the higher interest rates have yet to show their full negative consequences. It is probably only a matter of time before GDP growth in the US goes into reverse just like Europe's has.

Our View on Monetary Policy

- The **Fed** will not raise interest rates any further
- **SNB** may move into positive real interest rate territory due to low inflation rate

- High core inflation rate forces **ECB** to raise interest rates further
- **Restrictive monetary policy** increases potential for financial market stress

"Data-dependent" is the keyword for central banks

The major central banks have one thing in common: there is no longer a clear commitment to hike interest rates further. The European Central Bank (ECB) and the Swiss National Bank (SNB) are the most likely to show willingness to continue rising interest rates, even significantly if necessary. But some representatives of the ECB have softened their choice of words. The keyword that unites all major central banks is "data-dependent". So, the monetary policymakers are no longer on autopilot but will decide from one meeting to the next whether further tightening is necessary. In our view, the US Federal Reserve (Fed) has probably done its job and can now pause. But even in the US there is no clear signal from the Fed's ranks. The policymakers in Washington don't want the markets to feel too certain, as this could lead to an interest rate level at the long end of the yield curve that is too low in the eyes of the Fed.

Our View on **Government Bonds**

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neutral

- As long as **recession concerns** prevail, yields at the long end of the yield curve will not rise significantly
- **Record forward sales** of US Treasuries as a contra-indicator pointing to falling yields

- **Inflation in the eurozone** remains well above target, which could force the ECB to tighten for longer
- Fed could decide on more rate hikes due to good **labour market numbers**

Don't get caught on the wrong foot

Things are quiet at the long end of the yield curves. There were no significant movements in the 10-year maturities in either Europe or the US. The financial markets are undecided about which direction to take. On the one hand, there are concerns about a recession, on the other hand, the US Federal Reserve is not sending any signals as to whether the interest rate hikes are behind us. The market participants' consideration is clear: they do not want to be caught on the wrong foot and are therefore holding still. Our scenario is therefore: if a recession hits, yields will continue to fall. The record-high forward sales of US government bonds also fit in, because this is considered a contra-indicator. If yields at the long end of the yield curve continue to fall, these positions will have to be unwound, which would entail purchases of Treasuries. We therefore maintain our overweight in US and European government bonds and remain neutral in Switzerland.

Our View on **Corporate Bonds**

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neutral

- **Economy** performing better than expected
- **Declining inflation rates**
- **Interest rate hikes** in the US are likely to come to an end

- Banking crisis in the US leads to restrictive lending – **a credit crunch is looming** (see here)
- Our **scenario of a hard landing** continues to gain probability
- **Safety is in demand**, prefer government bonds to corporate bonds

Safety first

After the agreement on the debt ceiling in the US, there was an easing of credit spreads. However, yields on government bonds have risen. It is expected that 700 billion USD of government bonds will be issued by September, and as much as 1,600 billion by the end of the year, in order to replenish the treasury's account. This withdrawal of liquidity basically burdens all risky investments such as stocks and spread assets. Unless the central bank neutralises these transactions, which does not look likely at the moment. First cracks are appearing in the US labour market. Overall, more and more indicators confirm that we are on the brink of a recession in the US, while the Eurozone has already taken the plunge. Based on our scenario of a hard landing, we are avoiding credit risks such as high yield or lower investment grade qualities and prefer government bonds.

Our View on **Equities**

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strong underweight

- Some investors are still on the **sidelines**, offering potential for a further price rally
- **End of rising policy rates** draws closer

- **Economy** continues to weaken, which is not reflected in share prices yet
- Ambitious earnings expectations from analysts provide **potential for disappointment**
- **Valuations** are rising again despite the difficult economic outlook

A diverging picture on several levels

Globally, a divergent picture is emerging. While the stock markets in the US and Japan developed positively last month, they were weak in Europe and China. After better than feared quarterly earnings numbers and the resolution of the dispute over the US debt ceiling, the focus is again on monetary policy and macroeconomic data. In particular, the weak economic data coming from China which points to falling demand from the West, especially from European companies. Thus, new orders continue to fall everywhere, which is likely to reduce future sales and profits. However, this is hardly reflected in the estimates of analysts yet, some of whom have raised their forecasts for the second half of the year. This has increased the potential for disappointments, especially in the event of a negative economic environment, also because valuations have risen further at the same time.

Our View on **Equities USA**

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underweight

- **End of interest rate hikes** looms in the USA
- S&P 500 exits **bear market**

- **Low market breadth** poses a threat to index performance
- Orders and order books at **recession levels**
- **Valuations** do not reflect the deteriorating economic environment

Investors rely on hope

The US stock market continues to puzzle investors. The S&P 500 index is back in bull market territory. However, on closer inspection, this year's performance is due solely to a few large tech stocks, especially those related to artificial intelligence, and due to an expansion in valuations. Small caps, on the other hand, clearly lagged behind. The low market breadth may represent a risk for the overall market. In addition, the danger of a recession is currently being ignored, although more and more indicators point in this direction. For example, orders have developed weaker than expected and the purchasing managers' indices (PMI) for the order books in the US in both the manufacturing and non-manufacturing sectors are now at the level of a recession. On top of this, there is the threat of a possible liquidity withdrawal as the US Treasury needs to replenish its coffers within a few months following the dispute over the debt ceiling.

Our View on **Insurance-linked Securities**

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neutral

- Asset class has never been **as attractive as it is now**
- First indications point to **below-average storm activity** in 2023
- Florida law changes in favour of insurance and cat bonds

- Just one storm coming ashore in the wrong place (landfall) **can cause enormous damage**

Best market since cat bonds have existed

The first quarter of 2023 brought the best performance for insurance-linked securitites since 2002, due to the massive increase in premiums. Currently, the return before losses is over 15 %; losses of 2.5 % are modelled. The first forecasts for this years' hurricane season (1 June - 30 November) are currently coming in. All models point to an "El Niño" year, in which fewer hurricanes are expected. However, forecasts at this early stage should be treated with caution. Ultimately, the decisive factor is how many hurricanes make landfall and whether they destroy insured infrastructure. Another plus is the legislative change in Florida in favour of insurance and cat bonds. It is estimated that past losses would have been 20 % to 40 % lower as a result. The asset class is thus arguably in the best position it has ever been in since its inception.

Our View on Currencies

- **EUR** still has potential for suprises
- **GBP** recently benefited from higher key interest rates and the narrowing interest rate differential against the **USD**

- **Emerging market currencies** have only limited upside potential due to inflation risks
- **Turkish** lira still under the spell of politics

Franc: Support from the SNB

The franc remained firm, although the euro tended to gain against the dollar over the past quarters. So far, we assumed that the franc would depreciate at least somewhat against the euro. But it is receiving support from the Swiss National Bank (SNB). The latter is intervening in the forex markets and is reducing its foreign currency holdings. A look at the corresponding statistics shows that this is happening. Both the foreign exchange reserves and the deposits of the commercial banks at the SNB have fallen significantly. We thus have to acknowledge that the franc is unlikely to weaken for the time being, simply because the SNB is preventing it from doing so. We are therefore adjusting our price target (EUR/CHF 0.96 to 1.02) and expect the franc to move sideways against the euro within this range.

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