Our View on 2024

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VP BANK

Our View on 2024

History repeats itself when it is time for new year resolutions. And every year, forecasts are made.

We are also making forecasts. Sometimes they are right, but often, like the ones of other forecasters, they are not. They are not useless, however. But more helpful than the forecast itself is the preceding analysis.

For example, the trend in inflation shows that central banks will soon have the possibility to reduce key interest rates. Whether they will lower rates in June, July or August is less important. What is important, though, is that they will cut interest rates.

If you were to base an investment decision solely on the exact timing of the first interest rate cut, disappointment would probably be inevitable. What we try to do is construct portfolios that are as robust as possible and not too vulnerable if the markets do not develop exactly as we had expected.

Looking ahead to the new year, we can say bonds appear more attractive than equities. We have now added high-yield bonds with a short duration to the portfolio.

If central banks do not cut interest rates or only much later than expected, these bonds would still perform relatively well due to their high yields to maturity. You can read our assessment of the opportunities and risks for other asset classes in this document, in more detail than usual and with a view to the new year.

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

Our View on the **Portfolio**

- **Money market investments** pay more than inflation in many currencies
- Attractive yields to maturity for **high-yield bonds** with short residual terms
- **Emerging market bonds** with yield advantage over government bonds from Europe or the USA
- **Recession risks** have been pushed too far into the background
- Dominance of a few stocks leads to **concentration risk in the US equity market**
- **High profit expectations** combined with cautious corporate comments

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

(Base: Mandate CHF balanced)

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	●●●○○

Our View on the Economy

- **Falling inflation rates** open up possibility for central banks to cut interest rates
- Signs of **stabilisation in the manufacturing sector** - albeit at low levels

- The **eurozone** remains economically depressed
- Despite an improved outlook, the **global economic environment** remains difficult

New year, old problems

Our outlook for 2024 promises little prospect of improvement. This is due to the catch-up effects after the COVID pandemic, which led to a special economic situation in 2023. These effects will be on the wane and the interest rate hikes by the central banks will have a negative impact. Added to this are geopolitical conflicts, particularly in Ukraine and the Middle East. This will also have an economic impact. The energy infrastructure that has been built up in Europe over decades needs to be reorganised. In the US, the growth of recent years has been at the expense of a sharp rise in national debt and will restrict room for manoeuvre financially in the near future. And in China, with the end of the property boom, the construction industry has ceased to be a central pillar of growth. At least the falling inflation rates offer hope. This gives central banks space for monetary easing in the coming year.

Our View on Monetary policy

- **Inflation rates** in the US and the eurozone will fall towards the central bank target of 2% by the middle of the year
- Easing inflationary pressure opens up **scope for interest rate cuts**

- Unexpected **second-round effects** could fuel inflation again and stand in the way of monetary easing
- Continued solid growth of the US economy could **prevent monetary easing in the US**

Rate cuts in sight

The starting position is favourable: inflation rates have fallen considerably in recent quarters. And most central banks have raised interest rates significantly. They are now in the restrictive area, where key interest rates are above inflation rates. At the same time, economic weaknesses cannot be overlooked. The eurozone is in recession, growth in the US is set to slow significantly and China is facing a whole range of structural difficulties. If the economic environment deteriorates and inflation rates continue to fall, central banks will cut interest rates in 2024. In our view, the Fed could cut the key interest rate by 125 basis points and the ECB by 150 basis points. For Switzerland, however, we expect the policy rate to remain unchanged. They are low at 1.75 % and the inflation is likely to rise again slightly in the coming months.

Our View on **Government Bonds**

underweight

- **Economic slowdown** will cause government bond prices to rise
- **Record forward sales** of US government bonds is a counter-indicator, which also speaks in favour of falling yields

- Easing **recession risks** could cause yields to rise again at the long end
- Fed could **cut interest rates only slightly** due to positive economic development

Normalisation of the yield curve

We expect interest rate cuts to be reflected in a lower level for shorter maturities. If central banks start to ease monetary policy, the current inverted yield curve, where short-term interest rates are higher than long-term rates, will return to a normal shape where long maturities are more attractive than shorter ones. As the prospect of falling policy rates has gained traction in capital markets in recent months, yields on long-dated government bonds have already moved down noticeably which means that financial markets anticipate rate cuts. Although we expect yields at the long end of the curve to fall further, the decline is likely to be limited - after all, a lot has already been priced in over the past few weeks.

Our View on **Corporate Bonds**

overweight

- **Bonds are attractive,** even compared to the stock market
- Falling inflation and lower yields add **price gains** to coupons
- Soft landing scenario **favours lower qualities**

- Looming recession makes longer corporate maturities **less attractive than government bonds**
- **Inflation fears** could flare up in a soft landing scenario

Economists against the market

Economic history has been rewritten with the lockdowns during the COVID pandemic. Based on the macroeconomic models that applied until 2019, a recession is imminent. However, the market is expecting a "soft" or a "no-landing" scenario. We expect, in view of the uncertainty, a recession and higher credit spreads. Nevertheless, we recommend high-yield bonds for short maturities because they react less sensitively. The credit spreads are sufficient for profits even if the US economy falls into recession. If, on the other hand, the market proves to be right, double-digit profits are on offer. For longer maturities, however, we advise against credit risk and favour government bonds. A mix of both strategies should smooth portfolio returns, regardless of the direction the economy ultimately takes. Overall, these are good prospects for the bond markets.

Our View on **Emerging Market Bonds**

overweight

- **Yield pick-up** over government bonds from Europe or the USA
- Economically and financially **more stable issuers**

- In the event of **financial market stress**, risk premia could rise compared to industrialised bonds
- **Defaults** in individual countries could put emerging market bonds as a group under pressure

High confidence

Yields on emerging market bonds have recently moved in line with US government bonds. They initially rose again before going back into reverse. Meanwhile, risk premiums remained largely unchanged. This shows the high level of confidence currently enjoyed by emerging market bonds. Based on historical patterns, these bonds should have lost due to the noticeable rise in global interest rates. But this was not the case. Many of the countries reacted early when inflation rates started to rise, which created confidence. Countries such as Brazil can now lower their key interest rates ahead of major central banks. In any case, we feel that our positive view on this market segment has been confirmed and we are maintaining our overweight position.

Our View on **Equities**

underweight

- **Expected interest rate cuts** should provide support for stock markets
- If the US is spared a recession, **profits** could **surprise on the upside**
- Some markets such as China are trading **at historically low levels**

- **Recession in the US** is imminent and not priced in
- After a strong performance, markets are all the more **dependent on key interest rates**
- **Dominance of US equities** leads to concentration risk in the MSCI World Index

Diffculties ahead

The global equity market is likely to face a difficult year. Large-cap US stocks in particular have contributed to the strong performance observed in the MSCI World. The economic recovery is expected to continue due to improved corporate earnings after a weak year and interest rate cuts which are not triggered by a recession. In 2024, the latter in particular will tip the balance after markets have priced in several rate cuts amid positive economic growth. If the US experiences a recession and the recession, which is already underway in Europe, turns out to be even deeper, prices are likely to fall after the increase of valuations. The US markets could lose their valuation premium compared to the rest of the world before the first interest rate cuts, even if all markets perform negatively in absolute terms.

Our View on **Equities Switzerland**

neutral

- **Key interest rate cuts** would support the market or even lead to valuation expansion
- **Lower valuations** than in other regions
- **Defensive profile** of the index compared to other regions

- **Recession** is not priced in based on share price performance in 2023
- Strong **franc means headwind** for corporate profits

Dependent on the US

Switzerland finds itself in a difficult economic position from which hardly any company can escape. Industrial firms are not expecting too much in the coming year. However, analysts estimate that 2024 will bring a recovery in profits. If the US slips into a recession, this is unlikely to go unnoticed by Swiss companies, not least because many of them will start the new year with shrinking order books. Some have already started to cut costs in order to defend their margins. In the event of a more severe recession, this would make further cost-cutting measures more difficult. A persistently strong franc is also hurting. The shares of some companies have partially recovered in 2023. However, there would have to be significant rate cuts without a recession for this trend to continue.

Our View on **Equities Europe**

underweight

- **Interest rate cuts** would support equities
- **Favourable valuation** compared to the US
- **Catch-up potential** of companies is more pronounced

- **High risk** of a severe recession
- **Earnings growth** expectations could be disappointed
- Price rally in 2023 may have **gone too far**

Higher earnings coming up?

Europe is facing similar problems to Switzerland. On the one hand, Chinese and European markets are weakening, which is affecting Germany and France in particular, and on the other hand, the absence of a US recession is the basic prerequisite for things not getting any worse. The biggest advantage over other markets, especially the US, is lower valuations. However, they are low for a reason. As in the rest of the world, analysts and strategists are expecting a recovery of earnings. And as in Switzerland, this hope could be dashed in the event of a deeper recession. Without earnings growth, some stocks may already have performed too well despite lower valuations. A recession could also trigger strong selling. However, timely interest rate cuts could mitigate this and support the equity markets.

Our View on **Equities USA**

underweight

- **Key interest rate cuts** would support the market or even lead to valuation expansion
- Smaller and medium-sized companies with **significant valuation discounts**

- US equities already **priced for perfection** and therefore vulnerable to setbacks
- Continued high probability of a **recession**
- **High profit expectations** combined with conservative corporate commentaries

Prices reflect best-case scenario

The Nasdaq 100 and the S&P 500 produced price fireworks in 2023. The main drivers for the good performance were the so-called Magnificent 7 (Meta, Alphabet, Microsoft, Amazon, Apple, Nvidia and Tesla). Without them, the recovery was rather weak. There was no recession in 2023, but we expect it to emerge in 2024. It can also be assumed that key interest rates will fall, whether in the context of a recession or not, as inflation falls significantly. At the current valuation level, the market is almost priced for perfection, so the risk on the negative side predominates. Smaller and medium-sized companies could still benefit as they are trading at a significant valuation discount. However, they are more cyclical and therefore more susceptible to recession.

Our View on **Equities Emerging Markets**

neutral

- **Favourable valuation** compared to the US market
- **India** as a potential new driving force
- **Investments** in the regions should benefit local companies

- **China** could continue to stand in the way of positive development in the emerging markets as a whole
- **Dependence on the US market** and the development of the US dollar
- **Political risks**, particularly in China

More favourable than for a long time

Emerging market equities performed very differently in 2023. Markets such as Taiwan and South Korea were able to benefit from the hype surrounding artificial intelligence (AI). India benefited from high economic growth rates and the ramping up of supply chains. As this is a longer-term trend, it is likely to continue for years to come despite possible technical corrections. The largest and most important market, China, on the other hand, is suffering from many problems, which has led to an outflow of foreign capital. These are not only short-term issues, such as a lack of economic policy stimulus, but also long-term ones, such as the relocation of production facilities and the consequences of demographics. As a result, the Chinese stock market is more favourable than it has been for a long time. At present, the risks still outweigh the opportunities, which is why China's recovery could still take some time to materialise.

Our View on **Insurance-linked Securities**

neutral

- **Record levels** of insurance premiums make major losses absorbable
- El Niño phenomenon often lasts two to three years and **favours the asset class**; conversely, La Niña phases are statistically rich in losses

- Natural disasters **cannot be predicted**
- A rare event, which should only occur once in 100 years, is possible at any time, which can lead to **considerable losses**

After the record year, a good starting position for 2024

Record-breaking sea surface temperatures led to an above-average storm year in the Atlantic in 2023. Thanks to the El Niño phenomenon, however, this did not result in any significant losses for cat bonds. In 2023, record-breaking premiums of 15% (in USD) resulted in the best performance for investors since the asset class was introduced 25 years ago. It is still too early to forecast storm activity for next year, but the favourable El Niño phenomenon may last two to three years. On the premium side too, with a coupon of around 9%, the starting position looks record-breaking again, just like last year. The interest rate on the money market is also slightly higher than in the previous year. If claims remain in line with expectations next year, investors can expect a similarly pleasing year.

Our View on **Gold**

neutral

- **Interest rate cut speculation** increases attractiveness of interest-free investments
- **Fragile geopolitical environment** reinforces safe haven status
- **Looming recession** in the US is supportive

- **Speculative positions** indicate an overbought level
- **Technical sideways movement** for more than three years

The red carpet is ready

Gold reached a new record high at the beginning of December because interest rate cuts could come sooner than previously expected. The movement was driven by the futures markets, as inflows into listed gold funds were small. The upside potential is therefore likely to be limited in the short term. However, we believe that the conditions for gold will improve over the course of the coming year, as opportunity costs will fall with the prospect of interest rate cuts. Gold will also benefit from its quality as a safe haven. This is because the geopolitical situation remains tense while at the same a recession is looming in the US. This should revitalise demand for listed gold funds and could drive gold prices above previous records in the new year.

Our View on Currencies

- The **dollar** will remain in demand in 2024
- The **Swiss franc** remains well supported, also thanks to the SNB selling assets

- The **euro is no** longer receiving **support** from the monetary policy side
- Appreciation of **emerging market currencies** remains limited due to geopolitical risks

No significant dollar weakness expected

The dollar has come under some pressure in the face of increasing expectations that interest rates will fall soon. The broad dollar index fell by more than 3%. In our view, however, it would be premature to expect a sustained weakness of the dollar. Politically and economically, the world will be busy in the coming year. In In the US, the presidential election will take place in November. The historical pattern shows that in election years, the dollar gains significant strength from mid-year onwards. Election polls are usually become more precise: uncertainty recedes and the greenback appreciates. So there will be a lot of movement in the coming months - especially if central banks actually start to ease their monetary policy. This uncertainty benefits the dollar in its function as a safe haven (see here for more on currencies).

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