

# Our View in May

10 May 2022



# The side effects of inflation

**Central banks are trying to show resolve. They are trying to fight inflation by raising key interest rates and selling their bond holdings. This will not remain without consequences for the economy. We are therefore sticking to our defensive portfolio stance.**

Currently, not a day goes by without some central bank announcing new measures to curb inflation. The US central bank, the Fed, attracted the most attention at the beginning of May.

Not only did it raise key interest rates by another 50 basis points, it also gave the go-ahead for the sale of Treasuries and mortgage-backed securities. The message is clear: inflation must come down.

But that will not happen overnight. The inflation dynamic has broadened, further fueled by the war in Ukraine. Admittedly, some of the effects that have driven up inflation will weaken in the coming months.

But even if there are no new price-driving effects, the annual inflation rates will only recede slowly.

The central banks are thus facing a dilemma. If they wish to accelerate the process, they have to be even more aggressive. But in doing so, they risk a recession.

If they do too little, there is a danger that inflation will become sticky, eroding consumer purchasing power for a long time. Consumer sentiment has already come down noticeably in recent weeks.

For financial markets, the current situation is almost like that of companies suffering from supply shortages: Good news is scarce. And improvements do not seem to be around the corner. Therefore, we confirm our underweight in equities and our defensive portfolio allocation overall.

Dr Felix Brill, **Chief Investment Officer**

# Our View on the Portfolio



- **Defensive allocation** of the portfolio
- **Japanese equities** benefit from the devaluation of the yen
- Insurance-linked securities as a **non economically-driven component**



- Continued **inflation worries**
- Increasing **likelihood of recession**
- **Central banks** under pressure

- ● ● ● ● 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**



- **Household savings** and backlog of orders mitigate economic impact of war in Ukraine
- **Energy transformation** in Europe is accelerated, opening up growth potential



- War in Ukraine impacts already **strained supply chain situation**
- **US economy** shrinks in the first quarter
- Increased **energy and food prices** weigh on private consumption

## **Economic slowdown**

Growth rates for the first quarter prove once again that the global economy is currently sailing in troubled waters. In the US, gross domestic product (GDP) shrank surprisingly and by a big number. An increased deficit in the trade balance and a reduction in inventories were the main reasons. In the Eurozone, the Italian economy recorded a minus, the French economy stagnated. Germany stood out positively with a plus of 0.3 % compared to the previous quarter.

Worryingly, consumer confidence around the globe is falling in the face of high inflation rates. Significantly higher prices for energy and food are reducing the spending budget. Recession risks for the Eurozone remain high for the time being. US growth will be weak.

# Our View on Monetary policy



- Fed has **largely mapped out** its monetary policy course for this year
- SNB can **still take some time** with tightening monetary policy
- ECB addresses **inflation risks**. A first interest rate hike in July has become more likely



- Monetary policy is currently **walking a tightrope** between increased risk of recession and high inflation

## Fed is making a splash - ECB (still) waiting

The US Federal Reserve raised the key interest rate by 50 basis points at the beginning of May. The target range for the federal funds rate is now between 0.75 % and 1 %. At the same time, the Federal Open Market Committee decided to reduce the size of the balance sheet. The holdings of Treasuries and mortgage-backed securities will be reduced by USD 30 and 17.5 billion per month, respectively, starting in June. After three months, the monthly sales volume will rise to the previously announced USD 95 billion. Of this, USD 60 billion will come out of the portfolio of US government bonds and USD 35 billion from mortgage-backed bonds. The monetary policy baton now passes to the European Central Bank (ECB). Recent statements by ECB members indicate that the first interest rate hike could take place as early as July.

# Our View on Government bonds

● ● ○ ○ ○  
underweight



- Economic uncertainty reduces the risk for a **significant rise in yields** at the long end of the yield curve
- Monetary tightening is now largely **reflected in government bond prices**, limiting the potential for further significant price declines



- Fed reduces bond holdings, **Treasuries lose support**
- ECB is preparing **to end bond purchases**

## Peak hawkishness

The rise in yields continues. 10-year US government bonds are yielding around 3%. The European 10-year benchmark yield is scratching the 1% mark. Even in Switzerland, yields of over 0.80 % can be found at the long end of the yield curve.

But the air is getting thinner. The US Federal Reserve can hardly become more aggressive in its choice of words. There is now talk of "peak hawkishness" (determination to raise interest rates). The market's technical situation also shows that this has gone too far. Moreover, inflation rates are likely to fall in the coming months taking some of the edge off the current inflation debate. Although US Treasuries are losing support due to the balance sheet reduction by the Fed, a look in the rear-view mirror shows: When liquidity is withdrawn from the market, recession risks increase, which in turn can boost demand for government bonds as a safe haven.

# Our View on Corporate Bonds

● ● ● ○ ○  
neutral



- Positive outlook for **corporate earnings**
- **Excessive expectations** for the Fed's interest rate course of action



- **Fragile situation** in energy markets - an escalation cannot be ruled out
- Central banks react with a delay (behind the curve)
- Inflation **bites harder and harder**
- **Supply chain risk** due to lockdowns in China

## Corporate bonds hit doubly

Corporate bonds have benefited from the expansion of central bank balance sheets in two ways. Firstly, through the falling risk-free yields and secondly, through the resulting search for additional yield. As a result, credit spreads have fallen far below the level that would have been achieved in a free market. In the event of a normalisation of monetary policy, corporate bonds are thus more affected than government bonds. The situation is aggravated by high leverage - corporate debt in the US has more than doubled since the financial crisis in 2007. Rising interest rates and credit spreads thus hurt even more. The distortion of credit prices is also likely to have led to misallocations. Debtors who would not have received finance at market prices are likely to be the first to falter in an adverse environment.

# Our View on Equities

● ● ○ ○ ○  
underweight



- **Robust earnings** in the first quarter
- Solid **labour market situation** in Europe as well as in the US
- **Attractive valuations** in Europe and emerging markets



- Technology stocks remain **under pressure**
- Continued high **inflation**
- **Rising capital costs** increase credit risks

## Markets remain volatile

Although most companies did very well in the first quarter, this did not translate into higher share prices. The worry about the negative consequences of a tighter monetary policy is too deep-seated.

So far, companies have been able to absorb both higher capital costs and higher production costs triggered by inflation. The key question is, for how much longer. To make matters worse, the very companies that led the upward trend for more than a decade are now disappointing. It seems that the current consolidation will trigger a new trend, but this will be driven by other, new narratives. We expect that the orientation phase will continue for a while and that volatility will remain elevated. A defensive positioning is still advisable.



# Our View on Equities USA

● ● ○ ○ ○  
underweight



- Strong **labour market**
- **Tactical advantage** through increased demand in the energy, raw materials, food and defence sectors



- **Correction** in global growth stocks
- Continued **high fundamental valuations** compared to other regions

## Defensive positioning

The good labour market data signal some resilience of the US economy against inflation. The reason why US equities are not rising is the correction of global growth stocks. This began in February 2021 in China and is now also reaching large-cap US companies. The shares of Amazon, Netflix, Spotify, but also those in the electric mobility sector such as Rivian, Lucid or Nikola are losing massively. This echoes similar movements in the Chinese market.

This share price correction does not seem to be over and is fueled by worries about tighter monetary policy. Defensive positioning with a focus on business models yielding stable cash flows, good balance sheet management and above-average returns still seems appropriate.

# Our View on Alternative Investment - Gold

● ● ● ○ ○  
neutral



- Gold is seen as a **safe haven** amid geopolitical uncertainties and increased volatility in equities
- **Net inflows** into gold ETFs drive up prices
- Increasing **recession** worries



- Stronger USD erodes **purchasing power**
- **Rising bond yields**
- **Falling jewellery demand** in China and India

## Between interest rates and recession risks

Gold does not yield an ongoing return. If interest rates rise, the opportunity costs increase. That would actually speak against gold at present. In the past, however, the gold price has on average performed significantly better than the US stock market in the months following the Fed's first interest rate hike. This also applies to the last rate hike cycle in 2017 and 2018. Despite increasing headwinds from rising interest rate expectations, higher real interest rates and a stronger US dollar, the gold price has also proved resilient in recent months. This reinforces our view that gold is an important building block for portfolio construction. Especially in times when the uncertainty in financial markets is particularly pronounced.

# Our View on Currencies



- The euro has some **catching up to do** against the US dollar and the Swiss franc
- **High-beta currencies** could gain if there were a de-escalation of the war in Ukraine



- **Russian rouble** remains depressed
- Recovery potential of **emerging market** currencies remains limited due to inflation risks
- Japanese central bank maintains its **expansionary course** weighing on the yen

## Euro with catch-up potential

The dollar has had a strong run and gained against almost all currencies. Against the euro, the greenback improved to 1.05. From a market perspective, however, the EUR/USD currency pair is now showing a glaring divergence from the 200-day line, so that a correction is overdue. At the same time, speculative investors are betting heavily on a further strengthening of the dollar through futures trading. In the past, this pattern led to the opposite, a depreciating greenback. And on top: the US budget deficit and the US current account (twin deficits) show a post-war record. So there are enough reasons for a devaluation of the USD.

# Authors and disclaimer

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