Our View in February

8 February, 2022

VP BANK

The monetary tightening has begun

Inflation is setting the pace and central banks are re-acting. The Bank of England has already raised interest rates, the Fed will follow suit in March and the ECB has initiated the tightening, at least in terms of com-munication.

How long is a risk a risk and not yet a reality? This question has probably been discussed at length by the governing body of the European Central Bank (ECB). After all, ECB head Christine Lagarde admitted that the latest inflation figures were higher than expected. Talking only about inflation risks was no longer an option. Lagarde therefore emphasised that the ECB would respond to new data. She no longer ruled out a first rate hike this year. First topic on the agenda, however, is the end of securities purchases.

The U.S. Federal Reserve has already gone further in this regard. It will end its bond purchases in March, and a first interest rate hike is also a foregone conclusion, with further hikes likely to follow soon. In addition, the reduction of the balance sheet will probably be tackled soon.

This regime change poses challenges for financial markets. Expectations are being adjusted and high valuations of companies are being questioned. Correspondingly, the start to the year on the stock markets was bumpy, and risk aversion has recently increased.

We continue to favour equities and maintain our overweight regardless of these developments. However, we are shifting the regional weightings. We are reducing US equities and increasing emerging markets and Japan in return. These two regions are now in line with Europe.

Monetary policy is acting and its credibility has not been questioned so far. This gives us confidence. According to our new indicator*, there is an improvement in supply chains too. Also, the incoming order situation remains very good.

In bonds and alternative investments, the current allocation remains unchanged for the time being.

Dr Felix Brill, **Chief Investment Officer**

* VP Bank Supply Chain Index (link)

Our View on the **Portfolio**

- The significant **underweight in government bonds** has proven its worth
- We are increasing the equity weight in **emerging markets** and **Japan**
- The **euro** has appreciation potential

- **US equities** due to high share of technology companies
- Monetary tightening to put pressure on **government bonds**

● ● ● ● ●	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**

- We expect a **boom in the manufacturing sector** as soon as material shortages wane
- **Transformation to a climate-neutral economy** supports long-term recovery

- **Material shortages** continue to slow economic recovery
- **Omicron wave** dampens activity in the services sector
- **Central banks** may overreact because of **inflation risks**

High growth discrepancy within the eurozone

Rarely have growth rates of eurozone countries been as varied as they were in the final quarter of 2021. While the Spanish economy was on the fast track, and the Italian and French GDP growing at 0.6% and 0.7% respectively compared to the previous quarter, Germany and Austria were on the decline. In the current and the following few quarters, growth in the euro area is expected to be much more synchronized. The recent recovery of key early indicators suggests that the eurozone will show more coherence, and that those countries which have suffered will return to positive growth rates.

Our View on **Monetary policy**

- **Fed's** set path for monetary policy leaves little room for surprises
- **No rate hikes** from the ECB yet
- **SNB** still waiting to adjust monetary policy

- Discussion about **the right monetary policy measure** intensifies
- **Balance sheet reduction** by the Fed is a risk
- Unexpected policy maneuvers could cause a stir in **financial markets**

The Fed is ready

The Fed has prepared market participants for the "lift-off." At its next meeting in March, it will most likely raise the benchmark interest rate by 25 basis points to a target of 0.25 to 0.5%. Meanwhile, four interest rate hikes in the current year are expected and a balance sheet reduction is expected. This was hinted at in the press release of the recent meeting of the Federal Open Market Committee (FOMC). At the accompanying media conference, Fed Chairman Jerome Powell surprised with his statement that the Fed could raise interest rates at every FOMC meeting this year. This would imply seven rate hikes. In our view, the Fed chairman merely wanted to signal that Washington was prepared to act if inflation rates were to remain high.

Our View on **Government bonds**

strong underweight

- The **options markets** imply renewed policy interest rate cuts in the US for 2024
- Government bonds **diversify** a portfolio

- The **Fed** will end its net asset purchases in March withdrawing some support for government bonds
- The **ECB** promises to tighten its monetary policy in the face of significantly higher inflation rates
- Government bonds are exposed to a **high interest rate risk**

Yields increase especially at the short end

The Fed's first rate hike is approaching. Historically, this lead to a flattening of yield curves at the same. This means that, at the short end of the yield curve, yields are rising more than at the long end. Previous interest rate hike cycles reveal that the behaviour of the 10 year US yields is far from uniform. This means: A further increase in yields at the long end of the curve is by no means written in stone. The more aggressive the Fed moves against inflationary risks, the higher the risk of an economic downturn, and the more likely it is, that the 10 year yields will be held back. That is precisely why we now see limited potential for further significant increases in the yield on 10 year Treasuries.

Our View on **Corporate bonds**

neutral

- **Inflation rates** are expected to **fall** throughout the year
- Companies in the **energy sector** provide a hedge
- The **long end** of the yield curve is approaching our target path

- Despite recent **price losses**, only the real yield of the 30 year bonds are positive
- A **recession** would negatively impact corporate bonds via spread
- If **supply chains** remain interrupted for longer than expected, inflation could remain elevated

Inflation effects

The new year has started with significant losses in bond markets. After the Fed, now the ECB is also surprised by the persistently high inflation rates. In the US, five interest-rate steps have already been priced for this year. Because wages do not keep up with rising prices, inflation has a negative effect on real incomes even without raising interest rates. As the long end of the interest rate curve has moved much less and is now slowly approaching our target, bonds are becoming increasingly attractive. Energy companies are particularly noteworthy. If rising energy prices keep inflation higher for longer, companies in this sector will benefit at least from falling credit spreads.

Our View on **Equities**

overweight

- **Positive economic outlook** for many advanced and emerging economies
- **Higher commodity prices** tend to benefit emerging economies
- **Transformation** towards net-zero emissions triggers high infrastructure investment

- **Valuations of US equities are high** while earnings are solid but growing moderately
- High costs, supply bottlenecks and rising wages affect **profit margins** negatively

Uncertainty about interest rate path

Since the beginning of the year, market participants have been nervous. First the Fed signalled interest rate rises, now the European Central Bank is forced to change course due to high inflation. Changes in monetary policy tend to be followed by major price movements. For rising interest rates mean higher capital costs, which, at a certain level, dampen growth. This effect is currently being processed by market participants. At the same time, the order books remain filled. Profit margins are high and robust. And both the technological and the environmental transformation of the manufacturing sector helps business activity very strongly. Increased stock-market volatility may continue for a few weeks but is not questioning the long-term growth path.

Our View on **US Equities**

underweight

- US companies show **solid earnings** with mostly positive surprises
- **New orders** at a robust level

- **Inflationary pressure** due to high producer prices and rising wages
- High **fundamental valuations** compared to other regions and own history

Technology sector in focus

Fear of deeper economic growth rates as a result of a Fed tightening has left the S&P 500 with the weakest January recorded since 2009. High inflation creates headwinds and leave already a mark on net profit margins. These include high energy costs, rising wages, and continuing supply chain problems. Until now, the companies have been skillful at managing these and the order situation remains very robust. The main question for the coming months will be whether the high growth expectations can be met. The recent drops in big names such as Meta Platforms (formerly Facebook), Netflix, Tesla or PayPal promise nothing good should there be disappointments. The US market will thus remain on a consolidation path in the first quarter.

Our View on **Alternative Investments - Gold**

neutral

- **Inflation protection**
- Consumers and central banks **support demand**
- In an environment of weaker economy and higher equity volatility **gold** is considered to be a **safe haven**

- **Stronger USD** reduces purchasing power
- Rising bond yields
- Prospects for **more restrictive monetary policy** have a damaging effect

Despite rising yields, gold remains interesting

When bond yields rose at the beginning of the year, leading to increased equity volatility, gold once again demonstrated its stabilising effect in the portfolio. Given that base effects can be expected to cause inflation rates to decline again in the coming months, gold is expected to continue its sideways movement. In theory, gold would have to record lower levels as interest rates rise, but history shows a different picture. As soon as the negative correlation with bond yields decreases, gold prices can be more firm in the months following the first interest rate hike. There is an increased interest in safe havens, because there is a risk that the economy will weaken - or even slide into recession.

Our View on **Currencies**

- **EUR** with a tailwind due to the **ECB's change** in monetary policy
- Defensive currencies such as **USD, CHF, EUR** are currently in demand

- **High-beta currencies** like the **SEK** are losers in a risk-on and risk-off environment,
- **Emerging market** currencies have limited recovery potential due to tighter Fed
- **High speculative net long positions** on the USD point to weakness in the greenback by way as a counter-indicator

The ECB, the Euro, and the potential for surprises

Inflation did not slow down in the eurozone in January as expected. Nervousness is therefore growing within the ECB. According to its President, the ECB will discuss further measures based on updated inflation projections in March. So the ECB finally seems to be moving towards effective risk management. At a certain point, simply talking about inflationary risks without taking action is no longer enough. If inflation projections are raised in March, which is likely, ECB president Christine Lagarde will force a more rapid exit from asset pur-chases. In this case, an earlier interest rate hike could also be on the agenda. First of all, however, a premature end to the purchase of securities is on the agenda. The change in direction in monetary policy gave the euro a boost. We expect further gains for the EUR.

Authors and Disclaimer

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Important legal advice