Our View in March

8 March, 2022

Far reaching consequences

The war in Ukraine is keeping the world on tenterhooks. And the consequences reach far beyond Ukraine and Russia. Energy prices are rising, fueling inflation and increasing the risk of recession. What counts for the portfolio is caution.

There is a war in Europe. The situation in Ukraine is dramatic. Reliable predictions about further developments are hardly possible at the moment; instead, the situation must be constantly reassessed.

In the last few days, the financial markets have reacted, sometimes violently, to new developments. Good news has been scarce.

Nevertheless, the European stock markets reacted with some gains to a media report according to which the EU is to issue new bonds to finance the energy supply and the increase of the defense budgets in the 27 member states. This implies that investors have not yet thrown in the towel.

However, this financial package alone will not be enough for prices to calm down. An end to the war is not yet in sight. The consequences will be felt far beyond the countries involved and Eastern Europe. Be it with a view to security and energy policy, be it in the economy.

The sharp rise in energy prices is fueling inflation. Filling up at the pump is draining the wallet, and all the more so as many people return to the office. This is not an easy situation for central banks, as concerns about inflation are now compounded by recession fears.

In our view, the risks in equity markets are dominant in the short term. Therefore, the Investment Committee decided at its monthly meeting to further reduce the position in European equities. So we are in fact tactically lowering the equity quota from neutral to underweight. We are thus reaffirming the already defensive portfolio orientation.

Dr Felix Brill, **Chief Investment Officer**

Our View on the **Portfolio**

- **Diversification** is crucial
- **ILS** and **gold** as proven stabilisers
- Risk-optimised stock selection outperforms capital market-weighted benchmarks

- Sharp **rise in energy prices** weighs on economic outlook
- **High volatility** dampens risk appetite
- **Uncertainty** about developments in Ukraine weighs on markets

● ● ● ● ●	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 **high order backlog** mitigate the economic consequences of the war in Ukraine
- Energy **transition** in Europe will be accelerated, opening up potential for growth

- The Ukraine war is straining the already tense **supply-chain** situation
- **Increased energy prices** dampen global growth
- Uncertainty could lead to restraint in **investment**

War in Ukraine dampens growth

For the European economy, but also for the global economy, the war in Ukraine will not be without consequences. The increased energy prices are a burden for the world economy. The war also reveals how complex the production processes are in the manufacturing industries Ukraine may not play a major role from an economic point of view for Western European countries as a whole, but the country supplies, for example, cable trees to car manufacturers. Without this key component the production lines are standing still for European car builders. So looking at the aggregated data obscures the actual dependencies. Still, we are not counting on the economic recovery to stall. This would only be the case if Russian gas supplies were to stop. However, growth rates will be significantly lower than originally expected.

Our View on **Monetary policy**

- **Fed** starts tightening monetary policy but is more cautions due the war in Ukraine
- **ECB** claims a high degree of flexibility
- **SNB** takes time with a change in monetary policy

- Questions about the **right monetary** policy **level** are becoming more important
- The Fed's **balance sheet reduction** remains a risk
- **ECB risks** not containing inflation in time if monetary policy is too loose

A difficult task for the ECB

With oil prices sharply rising, inflation rates continue to go up. In the eurozone, inflation rose to a record high in February at 5.8%. In the US, inflation rates are around 8%. With the US economy being less affected by the war, the Fed is giving the greatest weight to inflationary risks. The monetary policy tightening course is therefore picking up speed. The task for the ECB is much more difficult: The economic consequences of the war in Ukraine are much more pronounced in Europe, but there is also a risk of sustained high inflation in the eurozone. It is likely that the European monetary authorities will continue to claim a high degree of flexibility. However, a rate hike by the ECB in the current year has become very unlikely.

Our View on **Government bonds**

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strong underweight

- Geopolitical uncertainty increases demand for **longer term government bonds**
- Government bonds **diversify** a portfolio
- First **US interest-rate cut** based on money market prices expected for 2024

- **Fed** will end its net asset purchases in March meaning less support for treasuries
- **ECB** likely to show willingness to reduce sovereign bonds purchases
- **High interest rate risk**

Yields increase especially at the short end

Long-term sovereign bonds have seen a reversal in recent weeks. The war in Ukraine raises concerns about an economic downturn. In the US, the interest rate curve continued to flatten. The difference between the 10-year and 2-year US Treasuries was only about 0.3 percentage points. In bond markets, expectations are that the Fed is set for a series of interest rate hikes, while the economic outlook is declining. Much will depend on the continuation of the war in Ukraine. Given that the latter is difficult to predict, financial market participants will remain cautious. The potential for a significant increase in yields is currently limited.

Our View on **Emerging Markets bonds**

- Russia's **default** is already reflected in the emerging-market index
- **Higher prices for oil & co** help commodity-exporting emerging economies
- **Chinese bonds** diversify emerging markets

- Emerging market bonds may continue to suffer from short-term **risk aversion**
- Increased **political risks** in a range of emerging markets
- Long maturity of emerging market bonds carries **high interest rate risk**

Russia's default

The spreads on emerging market bonds have recently increased markedly. Compared to US Treasury securities, the spread has increased by around 100 basis points in recent weeks, based on the Bloomberg Emerging Index (USD), to now more than 440 basis points. The sub-index for Russian USD government bonds lost around 90% of its value. The latter explains the evolution of the overall index. With Russian government debt already reflecting a default, the risk of Russia has already been almost fully priced in the broad emerging market index. The further path of emerging market bonds now depends on the general risk sentiment rather than on Russia's credit risk. As long as the nervousness in stock markets remains high, the risk premium on emerging market bonds will not retreat.

Our View on **Equities**

underweight

- **Strong industry trends**, full order books and skills shortages provide solid foundation
- Shifts in **production chains** trigger additional impulse
- Increased **defense spending** in Europe provides impetus for engineering

- Emotional **market movements** may lead to further price losses, even in regions that have held up better so far
- An increased **country risk premium** will weigh on capital markets in the medium term
- New **challenges for profitability growth**

Simply too much

First a global pandemic, now a war. Both challenges overshadow two other issues preoccupying capital markets. On the one hand, a strategic consolidation phase following the dominant digital growth trend, on the other hand, the tightening of monetary policy. The individual related issues such as financing costs, supply chain disruptions, new security thinking (including on crypto-assets and data security) are feeding each other to some extent. It is likely that this crisis complex has not yet been processed at the current fundamental valuations, neither with regard to the consolidating technology sector and possible effects on the cost of capital, nor with regard to the risk budget of strategic investors.

Our View on **Equities Europe**

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underweight

- **Full order books** support the economy
- Recent **euro devaluation** increases international competitiveness of European companies
- Increased **defense spending** is beneficial for manufacturing sectors in Europe

- Emotional **market movements** may lead to further price losses
- The medium-term **cost of the war** is not yet foreseeable

European stocks under pressure

The war in Ukraine is triggering a period of weakness in the European equities. Higher commodity prices, supply chain problems but also lower valuations are the drivers of the price move downward. So far, however, the expected profit losses due to the war and its consequences have not yet been taken into account in the expectations. It is therefore important to observe in the coming weeks how this development will be assessed by market participants. The significantly lower valuations could therefore be deceptive. The slowdown or even suspending of production, seen for example in the automotive industry, will leave its mark through in the first quarter. The current situation remains tense and uncertainty in the markets will remain high.

Our View on **Alternative Investments - Gold**

neutral

- In the event of geopolitical uncertainties and increased volatility in equities, gold is considered a **safe haven**
- **Inflation hedge**
- Russia's export problems could **threaten supply**

- **Stronger USD** reduces purchasing power
- **Rising bond yields**
- Prospect for **more restrictive monetary policy**

Time to shine

If geopolitical uncertainty increases, safe havens are in demand. Gold benefits in such a market environment because of its high liquidity, stability and excellent diversification features. Driven by the war in Ukraine, listed gold funds again recorded net inflows, lifting gold prices to well above $1,900 per ounce. In addition to the increased risk aversion of investors, a further increase could also be driven fundamentally. According to the World Gold Council, Russia is considered the second largest gold producer (10% of the annual supply). More sanctions, or less willingness to export, could reduce supply. Moreover, as gold is seen as a hedge against inflation, rising energy and commodity prices also help.

Our View on **Currencies**

- **Safe havens** are currently in demand
- **EUR is** losing against a strong CHF and USD

- **Russian ruble devalues** and is de facto non-tradable
- **High-beta currencies** such as the SEK are currently losing
- **Recovery potential of emerging-market currencies** is currently limited due to geopolitical developments

It is all about safe havens

The Swiss franc and the US dollar are once again in demand as safe havens are sought after. While the euro is lagging behind these two currencies, it gains against a variety of currencies.

Geopolitics is, in any case, the central driver of currency markets. It is difficult to estimate how long this will last. But, if there were some easing in Ukraine in the coming months, recent movements in foreign-exchange markets could turn into the opposite. For this reason, we maintain our view and expect the euro to gain both against the franc and against the US dollar. In the short term, however, a strong dollar and a strong franc may be prevailing.

The detailed view on currencies can be found here: link

Authors and Disclaimer

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