

Our View in August

09 August 2022



Summer break

The financial markets have obviously taken this motto to heart in recent weeks. Stress relief on the bond markets, recovery on the stock markets. But the recovery effect can quickly fizzle out when reality catches up with us again.

Will it come or will it not? This was and still is one of the most discussed questions on the financial markets. By "it" we mean the recession in the USA. From a purely technical point of view, in the financial markets' terminology, we actually already have clarity. Real gross domestic product (GDP) shrank in both the first and second quarters. But that had a lot to do with statistical effects, such as a significant reduction in inventories. It doesn't really feel like a recession yet. This is particularly evident in the labour market. The labour market is still running smoothly, and there is still no talk of large-scale job cuts. So, is that the explanation for the emerging mood of recovery?

Well, only to a limited extent. The change in sentiment began just as expectations were doing the rounds that the US Federal Reserve could soon lower key interest rates

again. The prospect of lower interest rates and a Fed that supports the economy: These are good ingredients for the stock markets. This was evident not least in growth stocks, which have risen particularly strongly in recent weeks.

So far so good. We have seen this pattern often enough in recent years. But this time it is not really convincing. The Fed's hands are still tied because of high inflation. It could only make such a U-turn if the economy were to take a really bad turn. That, in turn, would not be good news for the equity markets. We therefore do not really trust the recent recovery. For the portfolio, this means fewer equities than usual.

Dr Felix Brill, **Chief Investment Officer**

Our View on the Portfolio



- **Defensive orientation** of the portfolio
- **Diversification** more important than ever



- **High inflation** continues to challenge central banks
- **Recession worries** weigh
- Possible **gas crisis** in Europe

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

Base: mandate CHF balanced

Money market

Bonds

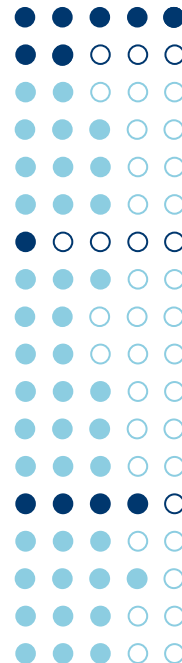
- Government Bonds
- Corporate Bonds
- USD Bonds
- Emerging Markets

Equities

- Switzerland
- Europe
- USA
- Japan
- Emerging Markets
- World and Themes

Alternative Assets

- Hedge funds
- ILS
- Convertible Bonds
- Gold



Our View on the **Economy**



- The **need for investment** is fundamentally large. Both the public sector and companies need to **invest** in the **energy turnaround** and **digitisation**
- The **service sector** is still benefiting from **catch-up effects**



- Russia could permanently reduce **gas deliveries** to Europe
- The US Federal Reserve is dampening economic development with its **interest rate hikes** and **balance sheet reduction**.
- High **energy and food prices** weigh on private consumption

Recession starts

What is too much is too much. High inflation rates, non-functioning supply chains, the war in Ukraine and now also a looming gas crisis are burdening consumers and entrepreneurs alike. The service sector is currently still benefiting from catch-up effects. Money is still being spent on holidays, trips and visits to beer gardens. But on the other hand, people are saving on their daily purchases. In autumn, consumers are likely to tighten their belts in all areas. Then even going to a restaurant is likely to become a victim of savings. These are not good conditions for private consumption. While a recession is already expected in Europe in the current second half of 2022, the USA could stay afloat a little longer. However, things are likely to go into reverse on the other side of the Atlantic in 2023.

Our View on Monetary Policy



- The **Fed** has largely mapped out its monetary policy course for this year
- **SNB** surprises with an unexpectedly significant interest rate hike of 50 basis points, thus creating confidence



- Monetary policy is currently a **difficult balancing act** between noticeably increased risks of recession and stubbornly high inflation
- The **ECB** is only hesitantly addressing the inflationary dangers and is thus risking its credibility

Now the ECB is also on board with interest rate hikes

The ECB has now also started its cycle of interest rate hikes. In July, it went up by 50 basis points. This brings the era of negative interest rates to an end. In the US, the Fed continued to march ahead swiftly and raised the target range for short-term interest rates again by 75 basis points. But the clearer recession signals become, the more central banks will also take economic developments into account in their decisions. After all, an economic contraction would significantly alleviate price pressures. Moreover, base effects set in at the end of the year, which will lead to a decline in inflation rates. However, it is questionable whether the US Federal Reserve will lower the key interest rate next year, as expected by the markets. We do not expect it to do so, but simply do not anticipate any further interest rate hikes. In view of the still high inflation rates in 2023, interest rate cuts will not be an option.

Our View on Government Bonds

● ● ○ ○ ○
underweight



- **Economic uncertainty** leads to a noticeable decline in yields
- **A complete Russian gas supply freeze** could exacerbate the decline in yields, as in this case economic risks dominate over inflation risks



- **Fed reduces securities holdings**, Government securities thus lose support
- The ECB also stopped net purchases of government bonds and is **launching interest rate hikes**

Long-term yields switch to recession

The recession, which is becoming increasingly apparent, is pushing yields at the long end of the yield curve noticeably downwards. The calculation on the capital markets is: a contraction of GDP will lead to interest rate cuts. Whether the Fed & Co. will actually be able to bring themselves to lower interest rates in the coming year, however, remains questionable even in the event of a more pronounced slump in growth. Even if inflation rates fall towards the end of the year, for the time being the two-percent increase in the consumer price index desired by most central banks is a long way off. Therefore, the Fed, but also the ECB or even the SNB, are likely to stop their cycle of interest rate hikes, but not to reverse it. We therefore do not expect a further significant fall in yields in the short term. However, on the other hand, the potential for a significant rise is also limited.

Our View on Corporate Bonds

● ● ● ○ ○
neutral



- **Selectivity** is needed in difficult times
- The **commodity sector** (energy, metals, mining) are only slightly indebted and are likely to be more resilient.



- The current **credit** spreads do not cover the **risks** of a **recession**
- Even an **energy crisis** in Europe or further **supply chain** interruptions from China are not or insufficiently compensated for

Increased spreads, but no recession priced in

After almost a year of trying to gloss over the inflation issue with the word "transitory", the central banks now have to react with even more aggressive interest rate steps. Consumer sentiment in the US as well as in Europe has fallen to its lowest levels on record. Although US GDP shrank in the last two quarters, the administration refuses to speak of a recession. The bond markets agree. Credit spreads are elevated, but in a recession, they are typically more than double. The view seems to be gaining ground that the Fed will be back on a rescue course as early as spring and will support the market with interest rate cuts. Whether inflation rates will allow this until then is questionable. We recommend a cautious positioning. The commodity sector has low debt and is solidly positioned even in a recession.

Our View on Emerging Market Bonds



- A **Russian default** is already reflected in the emerging market index
- **Higher energy prices** generally help commodity-exporting emerging markets
- **Chinese bonds** diversify the emerging market segment



- Emerging market bonds may continue to suffer from **high risk aversion** in the short term
- High **political risks** in a number of emerging markets
- Long maturity of emerging market bonds entails **high interest rate risk**

High-yield emerging market bonds

For more than a year, emerging market bonds denominated in hard currencies (i.e., USD or EUR) have underperformed government bonds from the USA or the Eurozone, which are considered safe. Measured by the Bloomberg index for hard-currency bonds from the emerging markets, the maturity yield of this asset class is thus over 8%. This is generous, but it does not mean that the end of the road has been reached. In the event of a major global economic downturn, yields could go even higher. However, the risk-reward ratio increases with every further rise in yields. We therefore consider the addition of this asset class to a well-diversified portfolio to be attractive. If the trend in this asset class changes in the medium term, the price of these bonds will rise while interest rates remain high.

Our View on Equities

● ○ ○ ○ ○
strong underweight



- **Cooling commodity** prices lead to initial easing on the world markets
- **Easing** on the **interest rate** markets calms the growth segments
- **Robust corporate earnings** help stabilise the price capriciousness
- **Fundamental valuations** have cooled considerably



- Leading indicators cloud over
- **Weakness** in **retail** sector causes first waves of **layoffs** in the USA
- **Downturns** in **consumer goods** (including cars, electrical appliances, furnishings, apparel) hurt prospects

Summer pleasures

After some heavy losses on the global stock markets, which lasted until mid-June, an interim recovery is taking place in July. While Japan shines as the strongest region over the year, followed by Europe and Switzerland, it is mainly US equities that are now recovering better. Both the geographical and economic distance to certain geopolitical challenges play a role here. But also the fact that market participants expect interest rates to peak soon as the economy cools down. This favours growth companies and dampens fears about excessively high future financing costs. The downside of recessionary economic phases is still being ignored. The fluctuations on the capital markets are thus likely to continue, as expectations are once again very clearly ahead of the real economic conditions.

Our View on World Equities



- **Non-cyclical consumption** shows strong **price pass-through**
- Energy experiences strong boom due to high **gas** and **oil** prices
- **Sustainable industrial companies** are expanding their order books



- **Automotive** sector suffers from weakening demand and **rising production costs**
- **Electricity supply** suffers from **high** spot **prices** on the **energy markets** but also from the ongoing **drought**
- After a very strong two years, **online retail** is experiencing a **significant slowdown**

Robust earnings development

Many companies presented their business performance for the first two quarters quite satisfactorily. Price increases ensured strong sales figures for many companies. On the other hand, production and material costs were higher at the operational level. Very negative surprises tended to be the exception. On the contrary, many companies responded very agilely to the previous challenges (including costs, supply interruptions). While on average the outlook for the coming second half of the year is stable to positive, it can be seen that operating margins are coming under pressure. Companies with good positioning in the area of sustainable trend technologies (e.g., electromobility, automation & robotics) are recording strong order intakes and strong negotiating positions. Cost-intensive mass production, on the other hand, must continue to reckon with strong headwinds.

Our View on Gold

● ● ● ○ ○
neutral



- With geopolitical uncertainties and increased volatility in equities, gold is seen as a **safe haven**
- Interest rate cuts for next year priced in due to **recession risks**
- **Technical support** has held



- **Stronger USD** reduces purchasing power
- **Restrictive central banks** continue
- **Speculative investors** build up short positions

Recession risks cause interest rate expectations to fall

The negative sentiment on the gold markets was currently reflected in particular on the futures markets. Due to a strong US dollar and further rising real interest rates, speculative investors increasingly bet on falling prices. Recently, the price was able to stabilise again and build up momentum. On the one hand, this was due to the fact that an important technical support held, on the other hand, the macroeconomic environment has become increasingly gloomy, and the financial markets are already pricing in the first interest rate cuts in the coming year. Since gold does not yield a current return, the latter in particular is an important support factor. As the global uncertainties are unlikely to disappear in the coming months, we continue to consider a gold allocation as an important component in portfolio construction.

Our View on Currencies



- **The Swiss franc** could post further **gains** as long as the ECB continues to dither.
- Should Russia permanently cut **gas supplies** to Europe, the **dollar** could remain in demand in its role as a **safe haven**



- Upward revaluation potential of **emerging market currencies** remains limited in view of inflation risks
- The **Japanese central bank** remains on its **expansionary course**, which weighs on the yen

High bets on further USD revaluation

The euro came under further pressure against the US dollar and even briefly traded below parity. The ECB's interest rate hikes of 50 basis points could not give the common currency any tailwind either, because the new emergency programme TPI mixes monetary and fiscal policy, which is causing scepticism on the currency markets. The threat of a possible energy crisis in Europe also weighs on the euro. An insufficient amount of gas would plunge the currency area into recession, which in turn would prevent possible furthermore significant interest rate hikes by the ECB. So, there is a lot to be said against the euro. But beware: the high level of euro forward sales by speculative investors now signals gains for the common currency as a contra-indicator in the coming weeks. In any case, the surprise potential is clearly on the side of the euro.

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