Our View in October

11 October 2022

Not feeling good

Many risks, no signs for a quick turnaround. That is the current mood on the financial markets. We remain underweight in equities.

Economic leading indicators are not looking promising right now. For example, the German ifo business climate index, which is based on a survey of around 9,000 companies, fell across the board in September. What is more, no longer do only manufacturing companies record a deteriorating business climate, but also companies from retail and the real estate sector. High energy costs and rising interest rates are taking their toll obviously.

This can also be observed in many other countries. Interestingly, Southern European countries are currently doing somewhat better than their Northern peers due to the strong pent-up demand in tourism. But tourism alone will not be sufficient to prevent a recession in Southern Europe. And even in the USA, where the energy crisis is not as severe as in Europe, there is now hardly any more talk of a soft landing of the economy.

So, what happens if economic data surprises to the upside? Well, markets don't like it. At least this was the case with the latest US labour market report. When the report was published, the decline in the unemployment rate caused the US stock market to sell off. A robust labour market, so the market narrative, would force the Fed to continue to hike rates aggressively in order to tame inflationary pressure.

Such narratives can change quickly. We've seen it before. Until that is the case, however, we remain cautious. We therefore confirm our underweight in equities.

Dr Felix Brill, **Chief Investment Officer**

Our View on the **Portfolio**

- Going forward, **government bonds** will offer more protection for the portfolio due to higher interest rates
- **Continued cautious positioning** in equities

- Uncertainty about insured damage from **Hurricane Ian** weighs on insurance-linked securities
- **Symptoms of stress** in the financial system are increasing

●●●●●	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**

- **Energy price cap** prevents private and corporate insolvencies in Europe
- **Service sector** still benefiting from catch-up effects

- **Central banks** dampen economic development with interest rate hikes and balance sheet reductions
- High energy and food prices **weigh on private consumption**

Europe suffers from energy shortages

Key leading economic indicators continue to point to noticeably weaker global growth. The situation in Europe is particularly delicate. It is still unclear whether enough gas will be available through the winter. Governments are now trying to support companies and private households by capping energy prices. However, despite the price caps on electricity and gas, energy costs will have to remain noticeably above pre-war levels - in order to maintain incentives to save. The euro zone is probably already in recession, while the US economy is also likely to enter a recession. This has recently been indicated by the noticeably weaker economic data from the USA. In China, the economic environment remains challenging as well.

Our View on **Monetary Policy**

- **The Fed** is likely to raise its key interest rate by 75 basis points in November
- **The ECB** is likely to raise its key interest rates again by 75 basis points in October
- **The SNB** is also likely to raise its key interest rate by 75 basis points in December

- **Monetary policy** is more than ever a **tightrope act** between recession and inflation
- **Restrictive monetary** policy could even increase inflation in a risk scenario

Central banks commit to a restrictive stance

The discussion about how much more the Fed can do is picking up speed. Most recently, the ISM index for the manufacturing sector fell significantly, and companies' employment intentions have deteriorated noticeably. For this very reason, there are doubts whether the Fed will be able to maintain the high pace of monetary tightening. We expect the monetary watchdogs in Washington to decide on interest rate hikes of 75 and 50 basis points at their next meetings in November and December. This will mean that most of the Fed's work will be done. In our view, the interest rate peak in the current tightening cycle is in the range of 4.5%. We do not expect any rapid rate cuts. Inflation rates will be too high for the time being.

Our View on **Government Bonds**

neutral

- **Economic downturn** supports government bonds and limits potential for further rise in yields
- **US inflation rate** could fall more than expected in coming months

- Renewed **inflation concerns** could push yield up again
- Due to Fed's **balance sheet reduction,** government bonds lose important support

Discussion about the right measure of the Fed begins

Yields initially continued to rise before going into reverse gear again. Concerns about inflation and recession have been alternately taking command of the government bond markets for some time now. We expect the recession camp to prevail over the inflation camp. The debate about whether the Fed is not going too far with its monetary tightening is likely to put a cap on yields. What is more, there are now a whole series of indicators that speak for a downward trend in the US inflation rate. If this is also reflected in the core inflation rate, which excludes volatile energy and food prices, yields on long-dated US government bonds could go into reverse.

Our View on **Corporate Bonds**

●●●○○
neutral

- **Central banks may have overshot the mark.** In the UK, the bond market had to be propped up
- **Market forces gain the upper hand**, risks are compensated again

- **Credit spreads increased,** but still far from stressed
- Recession and higher interest rates will have a negative impact on **corporate profits**
- **Idiosyncratic risk** is significantly elevated, especially in Europe

Credit spreads rise

Although the Fed has reduced its balance sheet by less than 2% so far, bonds are posting massive losses. The days when companies could borrow money for next to nothing have led to misaligned incentives and debt excesses. The Fed reckons that 9% of all listed companies are zombies, i.e., they have to pay too much interest compared to their profits – other sources state about 30%. New issues have fallen by 80% this year, and banks are tightening credit criteria. Credit spreads have increased somewhat, but in recessions they are at least 5% higher than today, which would cause losses of 10% to 20% on high yield, depending on the rate of increase. On the other hand, the yield to maturity is now close to 10 %, the losses would be recouped by maturity.

Our View on **Equities**

strong underweight

- High **infrastructure investments** for the energy transformation provide long-term economic stimulus
- **Easing price pressure** on commodity markets points to a slowdown in inflation

- Continuing restrictive central bank policy puts pressure on **equity valuations**
- The full extent of the **energy crisis in Europe** will only be felt in the coming months
- Ongoing **geopolitical tensions**

A rough autumn

The very bitter September for capital markets was followed by a positive, albeit short-lived start into October. Defensive sectors such as health care and non-cyclical consumption, as well as less cyclical regions such as Switzerland or the Nordic countries, held up better. Nevertheless, the situation remains fragile. Recession risks are elevated, and the solution to the energy crisis in Europe has not yet survived the winter test. The reporting season, which is about to start, will help to provide more visibility on costs and thus on the development of profit margins. Equally important will be the extent to which the development of the last three months has influenced demand. Overall, we expect revisions to profit expectations for the current as well as the coming financial year.

Our View on **US Equities**

underweight

- High **independence** from world markets mitigates the negative impact of the energy crisis
- Compensating economic effects through **strong positioning** in the energy, defence and food sectors

- **Restrictive central bank policy** keeps interest rates high and reduces liquidity in bond markets
- Continued **technology consolidation**
- USA struggling to meet **climate targets**

Less earnings growth

Low capital costs and high liquidity are the lifeblood of US equities, this is now under scrutiny. The still high fundamental valuation makes US equities vulnerable to further corrections. On the other hand, the US economy has clear advantages in the current market environment and is benefiting from shifts in demand both in the energy market and agricultural products. While demand for high quality technology is also supportive, growth drivers are lacking. These are needed to keep valuations at above-average levels. Higher bond market yields, but also weaker earnings growth, are currently standing in the way. The probability of relative weakness compared to other regions thus remains high in the short term.

Our View on **Insurance-linked Securities (ILS)**

overweight

- Insurance premiums have **increased significantly in price**
- Damage from Hurricane Ian likely to lead to **further premium increases**

- **Uncertainty regarding insured losses** from Hurricane Ian may continue to weigh on premiums, but may also relieve them
- **Less profit potential compared** to equities or bonds if the financial market environment improves

Premiums rise after losses - also after Ian

Contrary to forecasts, the Atlantic hurricane season so far has been below average. But at the end of September, one of the two major hurricanes has now made landfall. Never before has West Florida been hit by such a strong hurricane as Ian. Significant insured losses resulted from wind, storm surge and flooding. Estimates of industrial losses are USD 50 billion but are still very vague. At the fund level, losses of 3 to 9 % are to be expected. In principle, losses in the insurance industry are only negative in the short term; they tend to have a positive effect in the longer term. They stimulate demand for insurance and thus increase premiums for new cat bond issues. We therefore see the current situation more as an entry opportunity.

Our View on **Currencies**

- The **ECB** changed its tone to demonstrate commitment in the fight against inflation. This provides upside potential for the EUR
- The **Swiss franc** remains in demand as a safe haven

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

Heavy burdens for the euro

The euro remains under pressure. The energy crisis, accompanied by a recession, and the election victory of a right-wing alliance in Italy are currently putting pressure on the European currency. However, there is still some potential to the upside. Particularly if the European Central Bank (ECB) raises key interest rates more sharply than previously assumed. While there are signs in the USA that inflationary pressure is easing, there is still no all-clear in the euro zone due to significantly higher energy prices. Inflation dynamics are higher than in the USA. If it turns out that the US Fed can shift down a gear and the ECB, on the other hand, has to do more, the euro would gain. We therefore confirm our medium-term outlook and expect the euro to strengthen somewhat against the US dollar.

Authors and disclaimer

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Important legal information