Zuger Kantonalbank

Portfolio

December 2022

Market overview and positioning

The last two months have been characterised by solid company results, a healthy labour market and stable consumer spending. Equity markets have recovered. And now US inflation data for October has supplied a further dose of good news. Is this accumulation of positive developments a flash in the pan, or are we about to turn a corner?

Companies perform better than expected

The last few weeks have delivered some clear pointers: despite the energy crisis, the war in Ukraine, inflation and rising interest rates, companies have performed relatively well. In the US, almost 60% of companies outperformed the expectations of analysts on the sales front. Given the sharp price adjustments made by a number of companies, there is nothing illogical about that when viewed in overall terms. But the figures were convincing at the earnings level too: just under 70% of companies exceeded expectations (see graph). US companies thereby supplied the first solid pillar for the equity market recovery.

Geopolitical events weigh less heavily

The slight improvement in sentiment was also supported by the easing of a certain amount of tension on the geopolitical front. The mid-term elections in the US unfolded without triggering any major dislocations. The energy crisis lost something of its severity thanks to well-filled gas storage facilities and the continuation (for now) of mild weather in Europe. Global supply chain shortages no longer look so critical, despite China's unrelenting zero-Covid policy. What's more, Russia appears to be increasingly isolated on the world stage in the Ukraine war, while the Ukrainian army continues to regain territory. All these factors provided a second pillar that gave at least a short-term boost to market confidence.

Inflation passes its peak

Equity markets then received a further shot in the arm from the latest US inflation data: inflation rose by 0.4% in October, which was below consensus expectations. There was evidence of a broad-based decline in the prices of goods. On the other hand, the prices of services continue to rise. Nonetheless, inflation appears to have already passed its peak, at least in the US. Viewed in absolute terms, the rate of inflation recorded a year-on-year decline for the fourth month in succession – albeit to a still high 7.7%. This was the third pillar of the recovery, and one that gave a boost to bond yields.

Market overview and positioning

Equity and bond markets on the rise

The new parameters delivered an improvement in financial market sentiment. Accordingly, equity prices rose generally. The fixed income markets also benefited from the decline in inflation rates. Government bonds reacted positively to the hoped-for peaking of inflation, as well as to the further accentuation of the economic downturn. Meanwhile, corporate bonds gained ground too as hopes for better financing terms rose. But have financial markets now veered towards overoptimism?

> "Monetary policy is working: The economic slowdown is gaining further momentum."
>
> Alex Müller, Chief Investment Officer

Economic momentum slows

Despite the silver lining on the horizon as far as geopolitical and inflationary developments are concerned, the fundamental outlook is not that rosy: The leading economic indicators have deteriorated further over the last few months. In the US they have been mixed. The real estate market is exhibiting signs of weakness due to the higher cost of financing home ownership. Over in Europe, the Ukraine war is weighing on sentiment, as is persistently high inflation against the backdrop of a weak euro and high energy prices. Corporate earnings can be expected to decline, given slower sales growth and lower margins.

Central banks maintain hawkish stance

Thus the equity market recovery clearly has risks attached. From today's standpoint, we believe it is too early to anticipate a change in the monetary policy course of central banks. We are not expecting them to counteract an impending downturn rapidly and decisively. The custodians of monetary policy, above all the Fed in the US, are unlikely to deviate from their hawkish course for the foreseeable future. Meanwhile, the European Central Bank (ECB) continues to tighten the monetary screws. In Ukraine, while the Russian aggressors have been pushed back, the gas pipelines to Europe remain closed for now. All of this provides sufficient reason to opt for a defensive position in the capital markets.

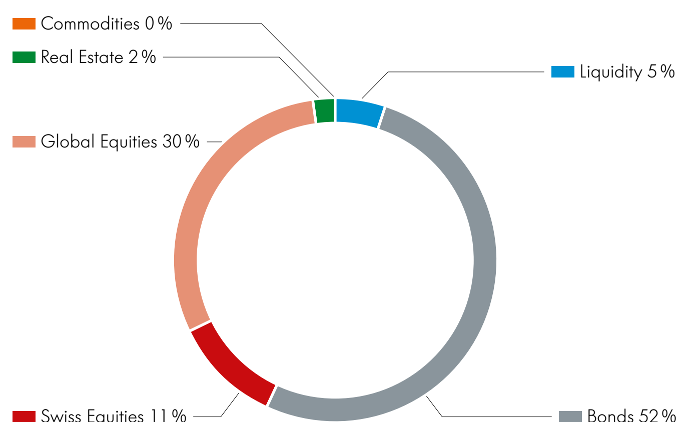
The last major interest rate rise?

Up until now, the US central bank (Fed) has pressed relentlessly ahead with its monetary tightening. At the start of November it once again raised its key interest rate significantly, by 75 basis points to 4 percent. This was the Fed's sixth rate hike since March 2022. Fed Chairman Jerome Powell stressed that this could be the final interest rate increase of any magnitude this year. The US labour market continues to develop strongly, but the economy has weakened significantly since 2021. Both consumer spending and real estate market activity remain subdued according to the Fed. Although we believe the Fed could ease up on the tempo of its monetary tightening, key interest rates have not yet peaked.

Remain invested, diversify risks

The ongoing cycle of interest rate increases is likely to fuel growth fears. But in the event of inflation rates coming down, hopes of lower key rates will give a short-term boost to equity markets. This tense situation is likely to translate into persistent market volatility as we approach the turn of the year. In view of high (and still rising) interest rates and a marked slowdown in growth, bonds are more attractive than equities in relative terms.

Strategic Allocation (Source Balanced Mandate)



Source: Zuger Kantonalbank

What does this mean for investors?

Reduce cash

The situation described above once again poses significant challenges to investors in this fourth quarter. We continue to recommend a defensive positioning. However, we have gradually reduced our cash quota since the last publication of Portfolio: a balanced invested portfolio should now contain around 8 percent cash. The combination of declining economic momentum and slowing rates of inflation can be expected to lead to stable or declining capital market interest rates.

Increase bond weighting

Within the bonds asset category, opportunities repeatedly present themselves for the active investor. Over the course of the year, interest rates have risen as a result of surging inflation and burgeoning economic worries (higher credit risk premiums). Unlike at the start of 2022, the current level of interest rates makes bond investments relatively attractive compared to equities. In the expectation of less aggressively rising rates of inflation we have increased the weighting of US government bonds, while at the same time building up our positions in Swiss and global bonds.

Retain equity positioning

On the equity side, we continue to recommend an underweight stance. This is being implemented both in developed nations (excluding Switzerland) and in the emerging markets. At current levels, valuations are not giving risky assets such as equities any real support. We believe corporate earnings will come under pressure. Compared to bonds, the risk premiums for equities have not risen. In the event of central banks around the world adopting a more neutral monetary policy stance, this would be an argument in favour of equity investments.

> "US inflation rates have probably passed their peak. This opens up opportunities on the fixed income front."
>
> Alex Müller, Chief Investment Officer

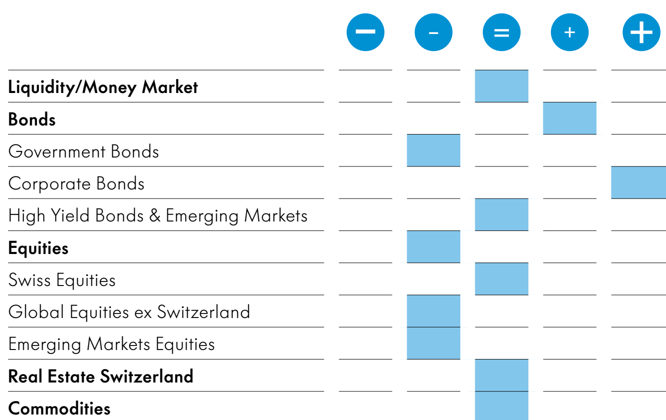
Swiss equities attractive

Swiss stocks continue to be heavily weighted, accounting for a third of the entire equity quota. The defensive mix of sectors is helpful given the uncertainties of the current environment. Thanks to the high quality of their business models, Swiss companies have strong price-setting power, while the same time generating attractive cash flows and high returns on capital. As a result, they should be able to cope well with the challenges of a weakening global economy.

Judicious portfolio composition

In the current environment, we believe a balanced mix of asset classes with a stronger focus on bonds is the way forward. Without any doubt, bonds remain a crucial component of any portfolio for strategic reasons. Structurally strong sectors, defensive stocks, and quality companies with stable margins should therefore be part of every investor's portfolio.

Tactical Allocation



	−−	−	=	+	++
Liquidity/Money Market			■		
Bonds				■	
Government Bonds		■			
Corporate Bonds					■
High Yield Bonds & Emerging Markets			■		
Equities		■			
Swiss Equities			■		
Global Equities ex Switzerland		■			
Emerging Markets Equities		■			
Real Estate Switzerland			■		
Commodities			■		

Source: Zuger Kantonalbank

Do you have any questions or thoughts regarding the current portfolio?

Simply contact us by e-mail (alex.mueller@zugerkb.ch) or call us at +41 (0)41 709 11 11.

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