Zuger Kantonalbank

Portfolio

March 2023

Market overview and positioning

Optimism proved the dominant emotion in the markets during the first few weeks of the 2023 investment year. The threats posed by inflation and risks of a recession disappeared almost entirely from the perception of investors. But a considerable amount of the ground gained was then conceded in February. What will the next few months bring?

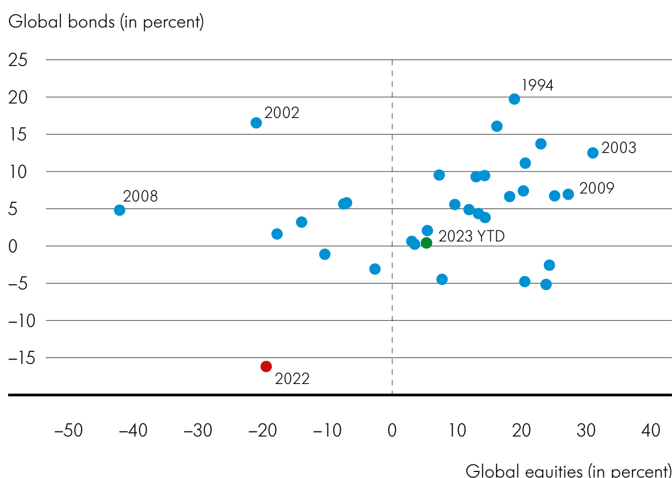
Prices recover

The prices of both equities and fixed-income instruments have recovered over the last three months. Indeed, this recovery was something of a mirror image – albeit less pronounced – of what happened in 2022 (see chart below). Three factors lay behind this development: Firstly, there was much more optimism in the financial markets, not least thanks to predominantly robust company results and a strong labour market. Secondly, inflation rates gradually declined – above all in the US and in Europe. And thirdly, the opening-up of China alerted many investors to a possible growth surge.

Solid economic situation

Over in the US, more than 80 % of companies have now unveiled their results for 2022. Sales revenues increased in an absolute sense, but earnings exhibited a decline on the previous quarter. In view of heady price increases in some areas and the simultaneous squeezing of margins, this development is comprehensible. There were no dramatic disappointments, but the outlook is not all rosy.

Annual return on equities and bonds



Geopolitical situation continues to be disregarded

Most strikingly of all, the improved market sentiment appears to disregard the geopolitical situation – which remains tense. Where the war in Ukraine is concerned, neither an end to hostilities nor even a ceasefire is in sight. And following the balloon incidents, relations between the US and China are more than just frosty. China's stance in the Ukraine conflict and its sabre-rattling over Taiwan are another cause for concern. There is no evidence of any de-escalation of tensions. Quite the contrary – the opposing positions have become even more entrenched in recent months. However, the financial markets appear to be ignoring this dangerous cocktail for now.

Benign labour markets

The latest monthly report on the US labour market ("non-farm payrolls") was once again positive. The number of newly created jobs rose sharply in January, while the US unemployment rate declined to 3.4 %, its lowest level for more than half a century. But in Europe too, labour markets are in rude health: according to the State Secretariat for Economic Affairs (SECO), for example, the Swiss unemployment rate stood at just 2.2 % at the end of January 2023. In other words, the environment for workers remains positive.

Wir begleiten Sie im Leben.

Market overview and positioning

Inflation in retreat

US inflation figures have been a further supportive factor over the last few months. The rate of inflation growth over the last 12 months declined once again in January 2023, coming in at 6.4% – the lowest figure since October 2020. Thus the peak inflation figure of more than 9% recorded in mid-2022 is retreating into the ever more distant past. That said, the current rate of inflation is still higher than expected, which means that the purchasing power of consumers continues to weaken. At the same time, producer prices are rising more strongly than expected. This is fuelling fears that inflation will not be pushed back down to the desired level of 2 to 3 percent all that quickly. Inflation rates continue to fall in the Eurozone, too, but remain at a lofty 8.6%. While a downward trajectory appears a given, we still believe it is too soon to simply dismiss all the problems that come with high inflation.

"The financial markets got off to a strong start to the new investment year. Declining rates of inflation and strong labour market data have been buoying sentiment. But volatility persists."

Alex Müller, Chief Investment Officer

The reopening of China – an opportunity

Despite waning rates of inflation, the fundamental outlook seems moderate to us at best. The leading economic indicators have deteriorated further over the last few months. In the US they have been mixed. The real estate market is showing signs of weakening against a backdrop of more punitive financing terms. Meanwhile, Switzerland's situation is in line with the global picture: Manufacturing is suffering a slowdown, whereas service indicators paint a picture of strength. Corporate earnings can be expected to decline, given slower sales growth and lower profit margins. We perceive positive stimuli in emerging markets, specifically China. The rapid reopening of the Chinese economy has triggered a rapid surge in mobility, which has in turn released significant catch-up potential. These factors make for a favourable regional investment environment.

Central banks continue to apply the brakes

As things stand, we still believe it is too early to anticipate a change in the monetary policy course of central banks. The guardians of monetary policy, above all the Fed in the US, will not have the freedom of manoeuvre to deviate from their hawkish course any time soon. Inflationary pressures remain, and must be brought under control. The European Central Bank (ECB) will tighten monetary policy further. The reappraisal of the situation by investors has resulted in yields on government bonds rising in the last few days.

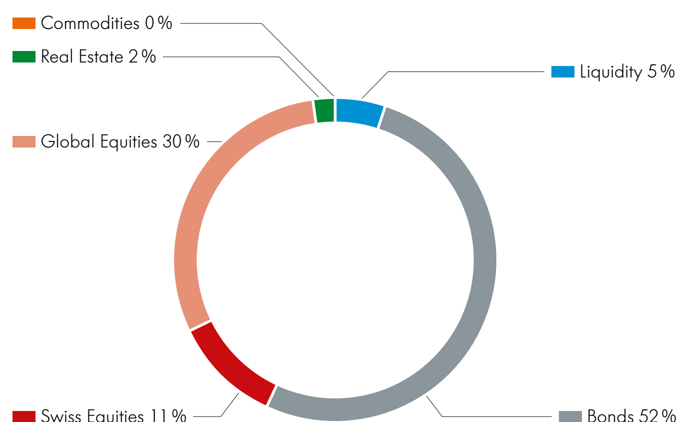
Investment outlook challenging

As we see it, the investment outlook remains quite challenging. In the current environment, high rates of inflation and restrictive central banks are continuing to throttle growth, despite extraordinarily strong labour markets. This implies risks for the profit margins of companies, while at the same time there appears to be little freedom of manoeuvre for central banks to cut interest rates. Interest rates can therefore be expected to remain close to their current levels for the foreseeable future.

The twin pillars: bonds and equities

Sooner or later, the ongoing cycle of interest rate increases should have an impact on economic growth. Will this lead to lower equity prices? Not necessarily: if inflation rates were to fall, hopes of lower key interest rates would be a positive for equity markets. This tense situation is reflected in persistent market volatility. Given this backdrop, we consider bonds to be more attractive than equities in the short term.

Strategic Allocation (Source Balanced Mandate)



Source: Zuger Kantonalbank

What does this mean for investors?

"Now looks like a good time to take profits on global corporate bonds. For investors looking for an alternative, Swiss real estate has become attractive again."

Alex Müller, Chief Investment Officer

Remain invested

The situation described above has helped to offset some of the losses suffered by investors in various areas. We highlight this in the graph "Annual returns on equities and bonds", which can be found on page 1.

Bonds: downsizing called for

Within the bonds asset category, opportunities repeatedly present themselves for the active investor. As a consequence of higher risk appetite, the credit spreads on investment grade corporate bonds have narrowed markedly over the last few months. We are therefore scaling down this position in our portfolios and selling the corresponding investments. In expectation of less aggressive inflation growth and uncertain economic development, we are continuing to hold a proportion of US government bonds.

Caution called for with equities

On the equity side, we continue to recommend a slightly underweight stance. We are implementing this in developed countries and in particular in Europe (excluding Switzerland). Valuations do not currently lend any significant support to higher-risk assets such as equities. Moreover, corporate earnings can be expected to come under pressure in certain areas, which could in turn suppress demand for equities and lead to interim declines in prices. Equities would then become attractive again if inflationary pressure subsides in a lasting way and central banks around the world revert to a more neutral monetary policy. Until this happens, however, investors should expect continued volatility and no clear equity trend.

Yes to Swiss real estate

We are building up our exposure to Swiss real estate investments. This asset class has suffered a severe correction in recent months. The valuation levels of Swiss real estate funds are now attractive, both from a historic standpoint and in view of the current level of interest rates. Furthermore, rental income can be expected to benefit from the higher interest rates (increase in reference rate). The cash flows of such investments will therefore remain strong, guaranteeing an attractive payout. What's more, given the backdrop of a structural shortage of housing in Switzerland due to strong immigration, the development of advertised rents could also support this trend.

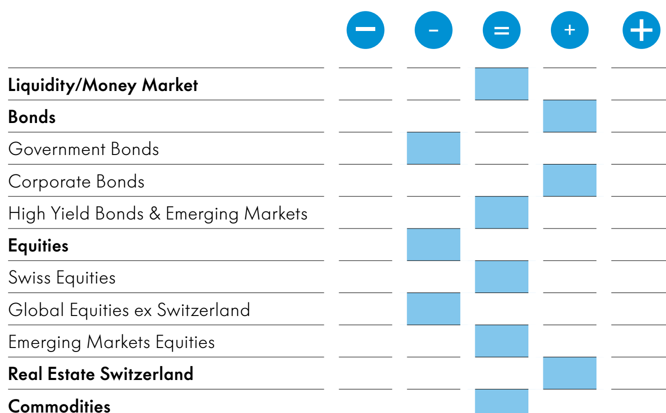
Blue chips look good

Many high-quality Swiss stocks have demonstrated their strength once again with their annual results. Thanks to the high quality of their business models, they were able to exploit their price-setting power, generate attractive cash flows, and impress the investor community. Swiss equities retain their high weighting, accounting for a third of the entire equity allocation. The defensive mix of sectors is beneficial in the current environment, which is characterised by uncertainty.

Adopt appropriate positioning

As things stand now, we believe a balanced mix of asset classes with a stronger focus on bonds is the way forward. However, equities should obviously remain a crucial component of any portfolio for strategic reasons.

Tactical Allocation



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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