Zuger Kantonalbank

Portfolio

May 2023

Market overview and positioning

The consequences of the rapid rise in interest rates have become all too apparent over the last few weeks. In Switzerland, turbulence in the banking sector triggered the downfall of Credit Suisse. Measures taken by central banks and government brought the situation under control, and the storm abated. The economic slowdown continues to gather pace, but companies are performing well. Time to adjust the compass.

Tremors in the banking sector

The effects that were expected from the brisk implementation of very restrictive monetary policy have now manifested themselves. Following on from the downfall of Silicon Valley Bank in California, Credit Suisse has had to throw itself into the protective embrace of its largest competitor. This seismic event was only possible with the invocation of emergency law and gargantuan state guarantees. In the case of both banks, the reasons for their demise were specific and home-made – and involved errors made over many years. That said, there is little question that the rapid rise in interest rates hastened and ultimately sealed the fate of these institutions.

Swift return of confidence

Through their vigorous intervention, central banks and government guaranteed the stability of markets. As a result, confidence was rapidly restored in the financial markets. The general perception that the two institutions in question were "special cases" had a calming effect. Furthermore, it can also be said that the banks – particularly in Europe – are now better capitalised than they were during the financial crisis of 2008/2009. But the current calm could turn out to be deceptive. The massive outflow of more than USD 100 billion in deposits from the regional US bank First Republic has reignited unease in the minds of investors.

US markets post strong gains

Over the last few weeks, equity markets have delivered gratifying returns, despite a banking crisis and deteriorating economic expectations. In the US, a number of developments have supported financial markets. Inflation rates have receded slowly but steadily from their highs. Consumer spending has remained resilient despite high prices. A strong labour market and real wage increases have solidified consumers' willingness to open their wallets. And companies have unveiled solid quarterly results: the current US reporting season has so far delivered good news. More than a third of companies have now released their results, with just under 60% exceeding earnings forecasts. This has surprised quite a few investors.

"The financial markets have coped with the banking crisis well so far: The focus now lies on economic development and company figures."

Alex Müller, Chief Investment Officer

Market overview and positioning

Equity markets driven higher by just a few stocks

A particular beneficiary of this environment has been the technology sector, which suffered a sharp valuation correction in 2022 due to rapid interest rate rises. More recently, strong figures released by Microsoft have triggered a rebound. However, it should be noted that the stock market rise this year has been driven by just a few large companies.

Economy looks set to weaken

Despite the positive development of the equity market this year, we are expecting the higher interest rates to weigh on markets. In the initial phase of the rate-hiking cycle we have so far seen lending costs rise for both companies and consumers, but with no decline in the overall credit volume. We are expecting this phenomenon to become much more visible going forward.

Higher for longer

Following the most rapid cycle of interest rate increases for decades, a "plateau phase" is now in sight – at least in the US. We are expecting interest rates to remain at elevated levels for the rest of 2023. As we see it, interest rate cuts remain an unlikely scenario, even though the financial market is currently appraising the situation differently. Any premature loosening of monetary policy would increase the risk of much higher inflation with the next economic upturn. We are therefore expecting the Fed to keep interest rates high, despite falling rates of inflation, weakening economic momentum and turbulence in the banking sector. A key argument for our stance is the still extremely strong labour market.

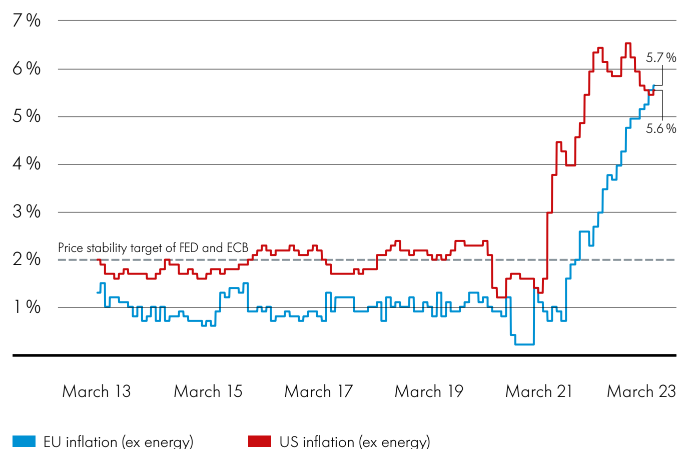
> "Bonds in Swiss francs and Swiss real estate investments remain attractive."
>
> Alex Müller, Chief Investment Officer

Growth and China support Europe

In Europe, economic growth has proved more stable than expected. Furthermore, China's abandonment of the zero-COVID strategy has provided a degree of economic stimulus.

This is something that has supported European equity markets in recent weeks. The dynamism of inflation is now waning in Europe too, with a slight time lag compared to developments in the US. However, the slowdown in core inflation in Europe – in contrast to developments stateside – has not yet really begun (see graph). That said, a further easing of the situation looks to be on the cards, as many of the supply chain problems that have been a feature of the last 12 months have now been resolved. On the other hand, the labour market is heated and wages are rising. Existing contracts are expiring, and employees see wage negotiations as a way of recovering at least part of the purchasing power they have lost over the last two years.

Core inflation remains well above 2 % – the price stability target of central banks



Prospect of even higher key rates

The combination of a banking sector that looks healthy relative to the past and upward pressure on wages will prompt the European Central Bank (ECB) to tighten monetary policy further. We are not expecting any monetary easing in 2023. Restrictive monetary policy can also be expected to have a slowing effect on the economy, which makes us circumspect about the future cyclical trend.

SNB fights inflation

We expect the Swiss National Bank (SNB) to follow the ECB's lead and raise interest rates again. The guardians of monetary policy in Switzerland are likely to be focusing on two key aspects – the level of the Swiss franc and the containment of inflation rates. Even the demise of Credit Suisse has not motivated the SNB to deviate from this twin objective.

What does this mean for investors?

Revised portfolio strategy

We have reviewed and adjusted our investment strategy as part of the annual review cycle. In the mixed mandates, the design of the portfolios now takes into account fundamental changes in the interest rate environment. Accordingly, Swiss bonds have a higher weighting in the portfolio whereas the cash allocation has been reduced.

Bonds – a focus on yield and security

Bonds that generate regular income streams will once again be automatically contributing to the portfolio return. In the current market environment we consider bonds to be just as appealing as equities, but with lower investment risk. Within the fixed income segment we prefer Swiss corporate bonds, which offer an attractive yield of 2%. In keeping with our expectations for economic development, Swiss bonds will also serve as a useful risk diversification tool in portfolios with equity exposure.

Equities remain susceptible to volatility

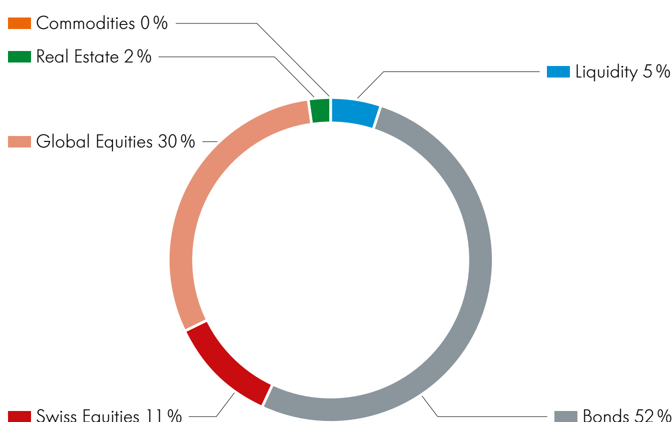
The accelerated rate-hiking cycle in the US and Europe over the last nine months will increasingly become evident in the real economy. Higher financing costs can be expected to depress corporate investment and thereby stymie economic growth. This raises a question mark over the development of corporate earnings. In our view, this negative earnings risk is not yet sufficiently reflected in either the corporate earnings forecasts of analysts or current equity prices.

On the other hand, it is reasonable to expect that a clear slowing of economic growth will go hand in hand with declining rates of inflation. This in turn would feed hopes of imminent cuts to key interest rates and therefore lend support to equity markets. Given these opposing tensions, we expect equity market volatility to remain high and are therefore sticking to our defensive positioning.

Real estate looking solid

We consider real estate funds to be attractive. In the first quarter of 2023, premiums declined to an average of 10%, which means valuations are now sufficiently reflecting the changed interest rate environment. Real estate funds are now once again offering a distribution yield of just under 3%, while at the same time offering some protection against inflation: the anticipated rise in Switzerland's reference interest rate to 1.5% in June 2023 will allow landlords to increase rents by up to 3%. In addition, they can pass on 40% of inflation to their tenants along with general cost increases. Market rents are also likely to be pushed up by the persistent scarcity of vacant housing, the pressure of net migration, and declining construction activity.

Strategic Allocation (Source Balanced Mandate)



Tactical Allocation

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

Source: Zuger Kantonalbank

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

Contact us by email (alex.mueller@zugerkb.ch) or call us on 041 709 11 11.

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