November 2023

Market overview and positioning

The third quarter was characterised by turbulence of varying kinds. Further rises in key interest rates weighed on bond investments and the likelihood of an economic downturn acted as a drag on equity prices, while at the start of October the terror attacks in Israel dragged geopolitics back to centre stage.

Middle East a powder keg

The terror attacks in Israel at the start of October are exacerbating an already tense geopolitical situation. At the same time, the escalation of hostilities is throwing a spotlight on the complex web of religious, historical and military tensions in the Middle East. Fears are growing that this conflict could spread, particularly through the active involvement of Hezbollah in southern Lebanon, or – in the worst-case scenario – with the entry of Iran into the fray.

Higher energy prices?

If the conflict were to escalate in a major way, the impact on oil and energy prices would be significant. Saudi Arabia and Iran are two of the largest oil-producing nations in the region. In the event of fossil fuel prices being pushed up on the supply side, there would be a sharp increase in otherwise declining rates of inflation in the industrialised nations in particular, which would in turn negatively impact economic development. We view this as a feasible risk scenario, as central banks would find themselves powerless in the face of such an external inflationary boost.

Inflation on the wane

So far, by contrast, things have been developing favourably on the inflation front. The rate of inflation in the US remained unchanged at 3.7% in September. The core rate, which excludes volatile energy and food prices, declined slightly from 4.3% to 4.1%. The ongoing downward trend is good news insofar as it heralds an imminent end to the rate-hiking cycle. On the other hand, both the absolute level of inflation and the tempo of its decline would suggest that it is not yet properly under control. This is also true of the Eurozone.

Interest rate peak in sight

Given this backdrop, we expect the US central bank (Fed) to refrain from any further interest rate rises for the time being. That said, key rates are likely to remain at their current levels for even longer, as the US labour market is in rude health. This further strengthens us in our view that the developed economies are now in the late stage of the growth cycle. We are expecting global economic growth to prove very low over the next few quarters. Our base scenario can be summed up in a few words: economic slowdown, declining inflation, restrictive monetary policy.

> "With the recent terror attacks in Israel, geopolitics are even more firmly back in focus – their impact on commodity prices and sentiment is being scrutinised closely."
>
> Alex Müller, Chief Investment Officer

Wir begleiten Sie im Leben.

Market overview and positioning

Handsome yields on government bonds

In view of the current situation, it is remarkable that the yields on government bonds in both the US and Europe have risen to multi-year highs. The yield on 10-year US government bonds recently stood at 5%, a level not seen since 2007. Quite clearly, investors are also demanding higher risk premiums on sovereign bond investments. This may be attributable to the high indebtedness of many nations, which has damaged their creditworthiness. For example, the US government continues to issue significant volumes of debt securities in order to finance its budget deficit for 2023 (currently estimated at some USD 2 trillion).

Equities on the back foot

Real interest rates have risen further in the face of declining rates of inflation and higher nominal interest rates. This has made borrowing more expensive. Sooner or later this will feed through into economic momentum. Equity markets have already anticipated this development and undergone a downward correction. As a result, investors have suffered losses not just in the third quarter of 2023, but also in the fourth quarter to date (see chart). With interest rates remaining persistently high despite geopolitical turbulence, investors have had additional reason to sit on the sidelines. We are expecting these uncertainties to remain in place for the time being.

"The turbulent environment will remain with us. High interest rates and the current reporting season are the key drivers of equity investments."

Alex Müller, Chief Investment Officer

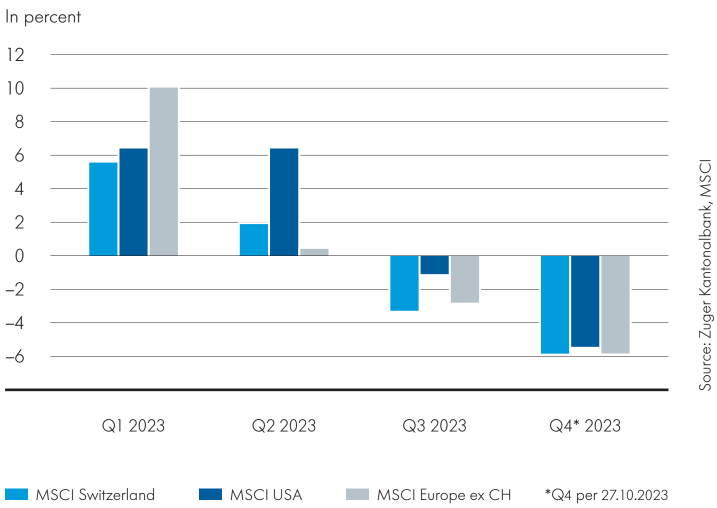
Europe experiencing a weak phase

The positive returns enjoyed by European equity markets this year were generated wholly in the first six months. Numerous factors are now dampening optimism – from high inflation and higher interest rates to slower economic growth, war in Ukraine, concerns over energy supply, and China's economic weakness. In October, the Eurozone's downward economic trajectory steepened further. The leading economic indicators declined more steeply than the market was expecting. This points to weak manufacturing development, while the downturn has taken on additional momentum in the services sector too. As the engine of the Eurozone economy, Germany is increasingly losing steam. To compound matters, commercial banks tightened their lending terms once again in the third quarter.

Tech stocks remain beacons of hope

Despite high and in some cases exaggerated valuations, we believe it is possible that the existing momentum in the US technology sector will continue. Cloud service providers and companies from the semiconductor sector could likewise benefit from the huge potential of artificial intelligence (AI). The extraordinarily strong boost unleashed by the possibilities of AI is persisting. This assessment is supported by a persistently robust growth environment: Purchasing managers indices for the US surprised on the positive side in October, with both manufacturers and the services sector recording stable to slightly increasing activity. Hopes of a soft landing for the US economy continue to look well-founded.

Equity region returns 2023



An appropriate portfolio structure

Our portfolio positioning reflects the current macroeconomic environment. We remain invested, and are sticking to our defensive equity positioning. Our ongoing underweighting of equities relates to Europe. A tangible weakening of economic growth is likely to go hand in hand with falling rates of inflation. This would feed hopes of cuts in key interest rates, which can be expected to support equity markets. In view of this persistent mix of factors, we continue to expect a challenging environment for investors.

What does this mean for investors?

Mixed reporting season

An important factor for developments going forward, particularly in equity markets, is how the third-quarter reporting season unfolds. The corporate results unveiled so far paint a mixed picture. As expected, companies from cyclical sectors have reported a slowdown in both order intakes and sales growth. The guidances issued by these companies have accordingly become more cautious. Although this had been factored into their stock prices to some extent, a continuation of the downward correction has nonetheless been apparent.

Pressure on Swiss equities too

Companies from more defensive sectors have so far mostly published figures in line with expectations. But even this has not been sufficient to prevent price declines. So despite its defensive character, the Swiss equity market has come under pressure in recent weeks. That said, the Swiss market contains a good mix of less cyclically-dependent stocks on the one hand and structural growth plays on the other. Thanks to the high quality of their business models, many of these companies have been able to exercise their price-setting power. They therefore generate attractive cash flows and are favoured by the market. Thus Swiss equities retain their high portfolio weighting – now accounting for a quarter of our entire equity allocation.

Will tech stocks once again play a supportive role?

Many hopes now rest on the results of the major US tech companies, which are due out shortly. These stocks have been a source of support over the year to date. Healthy financial data could fuel fresh hope and provide equity markets with support once again. However, if the figures disappoint, the downward pressure on equity prices would only increase.

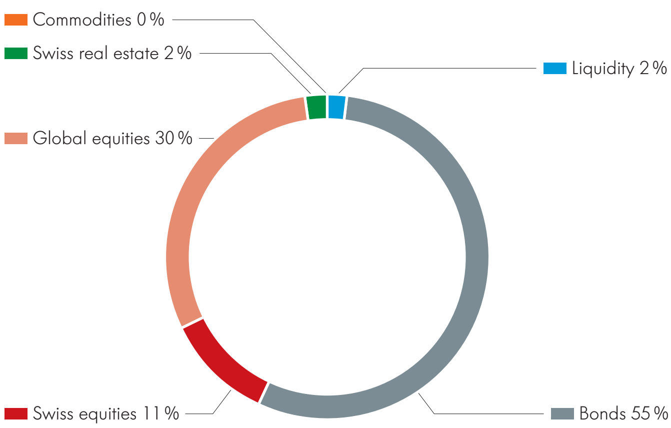
Europe unappealing – but cheap

We are maintaining our underweight equity positioning in Europe. The economic headwinds confronting the EU have strengthened. Record-low market volatility, little market breadth, and the feeble momentum evident in both manufacturing and the services sector call for caution here. On the other hand, opportunities will return in the medium term given the low level of current valuations. As we see it, the best approach for investors for the time being is to maintain a defensive positioning with a view to increasing exposure once the negative price trend has run its course.

Remain defensively invested

Overall, we remain defensively positioned. In other words, our equity weighting is below the long-term average. High-yield bonds also have a lower allocation than would typically be the case. We prefer Swiss corporate bonds that offer an attractive current yield. For portfolio hedging purposes, we are also still keen on US government bonds. Price gains here will be significant if capital market interest rates decline due to the dark clouds gathering over the economy.

Strategic positioning (based on balanced mandate)



Source: Zuger Kantonalbank

Tactical positioning

	−−	−	=	+	++
Liquidity/money market			■		
Bonds		■			
Swiss bonds				■	
Global Bonds		■			
High-yield bonds and emerging markets	■				
Equities		■			
Swiss equities			■		
Global equities ex Switzerland		■			
Emerging markets equities			■		
Swiss real estate				■	
Commodities			■		

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.