Zuger Kantonalbank

Portfolio

September 2023

Market overview and positioning

Equity markets consolidated over the summer months. The prospect of an economic downturn gave rise to uncertainty. Capital market interest rates barely declined, despite perceptible concerns over the development of the economy and lower rates of inflation. In the US, interest rates actually rose significantly. This environment opens up investment opportunities.

West in the doldrums

We are convinced that the world's developed economies are now in the late stage of the economic cycle. Over the next few quarters, we expect global economic growth to prove very low. Various leading indicators show that restrictive monetary policy on the part of central banks is choking economic momentum. Inflation rates can be expected to fall back towards the kind of levels targeted by central banks by the end of the year. Our base scenario can be summed up in a few words: economic slowdown, declining inflation, restrictive monetary policy.

Real interest rates reach giddy heights

A gradual plateauing of key interest rates is becoming apparent in the US. As we see it, US monetary policy is currently restrictive enough, with nominal interest rates having risen sharply and inflation having declined further in recent weeks.

"The global economy is stuttering: China is confronted by a property crisis, while Europe suffers from an ailing German economy."

Alex Müller, Chief Investment Officer

One reason for this development is the downgrading of the USA's credit rating by ratings agency Fitch, which prompted another surge in real interest rates (see chart on next page). The cost of borrowing has risen. We continue to view the scenario of interest rate cuts as unlikely, as the US economy and labour market are still strong. The US central bank (Fed) will keep interest rates high for the time being.

Light and shadow

There have been some pleasing developments, despite restrictive monetary policy. The US labour market remains very robust. This is reassuring for US consumers, who are still able to resort to savings for now. That said, consumers are likely to become more cautious. Rising credit costs, more rigorous lending guidelines and higher energy prices are eroding their financial flexibility. Nonetheless, the US real estate market is defying high financing costs, as a structural undersupply situation exists and only a small number of properties are changing hands. Fiscal policy programmes (notably the Inflation Reduction Act) and low corporate inventory levels are giving rise to hopes that the economic downturn will not prove all that severe, even if the relevant leading indicators for manufacturing are pointing to a slowdown. At a recent central bank meeting in Jackson Hole, Fed Chairman Jerome Powell summarised the situation as follows: "As is often the case, we are navigating by the stars under cloudy skies."

Market overview and positioning

AI boom intact

The possibilities of artificial intelligence (AI) are giving an unexpectedly strong boost to equity markets. Chip manufacturer Nvidia truly stunned investors with its latest half-year results. Other companies from the semiconductor sector as well as cloud service providers should likewise benefit from the enormous potential of AI in the future. We are maintaining our exposure to US technology stocks, even though valuations are now high. Steep equity prices are having to prove themselves in the high-real-interest environment, which rather limits their further upside potential.

Economic stimulus package for China?

The Chinese economy weakened significantly in the second quarter of 2023, with the real estate sector suffering in particular. Property prices fell sharply in the major cities. Both property sales and rollouts of new projects are in decline, while bankruptcies are adding further fuel to the fire. The initial euphoria accompanying the reopening of the economy following the coronavirus lockdowns has rapidly evaporated. Consumer confidence is now languishing at a low level. So far, the financial markets' great hopes of a comprehensive support package from Beijing have not been realised. The only medicine administered so far has been the monetary policy action taken by the Chinese central bank (PBoC). Nonetheless, investors would be advised to maintain their positions in this investment segment. Valuations are low, and the chances of political stimulus measures remain intact. Any such measures could prompt a change of sentiment.

"We remain underweight in equities, but are staying close to our strategic allocation."

Alex Müller, Chief Investment Officer

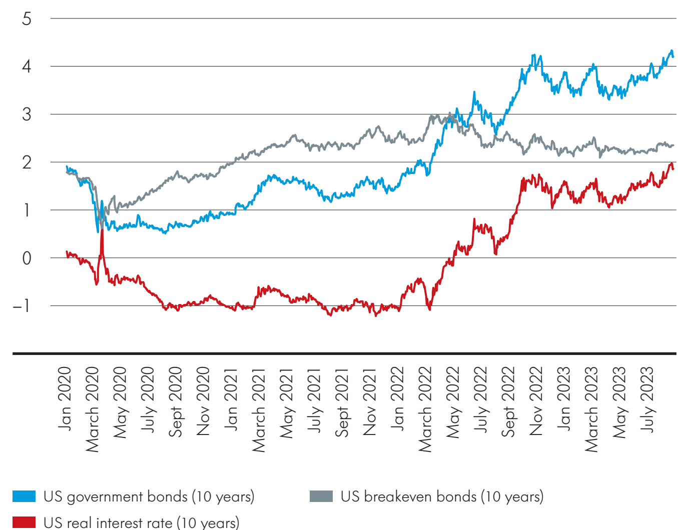
EU experiences recession

Purchasing managers' indices in the Eurozone declined steeply in August, as well as falling short of the market's expectations. This confirms the current weakness of manufacturing, while the downturn in the services sector is accelerating. Employment is developing hesitantly, yet at the same time the upward pressure on wages persists. It is therefore unlikely that Eurozone inflation rates will decline rapidly. For the time being, this means that the monetary-policy hands of the European Central Bank (ECB) are tied.

Adjustment to portfolios

Our portfolio positioning is aligned with the current macroeconomic environment. We remain invested, and are sticking to our defensive equity positioning. Our ongoing underweighting of equities relates to Europe, whereas in other regions we are neutrally positioned relative to the investment strategy. Visibility is low overall, and 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 could potentially support equity markets. Give this balance of opposing tensions, we expect equity market volatility to remain heightened in the second half of the year.

Development of real interest rates in the USA



Source: Bloomberg, Zuger Kantonalbank

Exploit bond yields

With their ongoing income streams, bonds make a key contribution to an investment portfolio's return in such an environment. Against this backdrop, we consider bonds to be attractive. In keeping with our forecast for economic development, they serve as a stabilising element in portfolios with equity exposure thanks to the diversification they offer. In the current environment we recommend that investors give bond investments a greater weighting than equities. Within the fixed-income segment we are prioritising government bonds, which will profit more than most from an economic slowdown and declining rates of inflation. We are maintaining our cautious view of bonds issued by companies of low credit quality and/or high debt levels (high-yield segment).

What does this mean for investors?

Remain solidly invested

The end of the rate-hiking cycle appears to be close. Growth fears may remain, but various indicators are pointing to only a mild downturn. You should therefore remain invested and keep a cool head. A solid and broadly diversified investment strategy is the best recipe for generating decent returns in the current environment.

Tech stocks remain beacons of hope

The extraordinarily strong boost unleashed by the possibilities of artificial intelligence (AI) is persisting. Despite high and in some cases exaggerated valuations, we believe it is possible that the extraordinary 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 AI.

Europe confronted by headwinds

We are maintaining our underweight equity positioning in Europe. The economic headwinds confronting the EU have strengthened. Record-low market volatility and the weakness of stimuli from China provide grounds for caution. By contrast, the Swiss equity market looks to offer superior relative potential. In our view, investors would be best served by maintaining a defensive stance for the time being. Switzerland is home not just to robust defensive pharma and food stocks, but also a number of companies that could benefit from the AI boom.

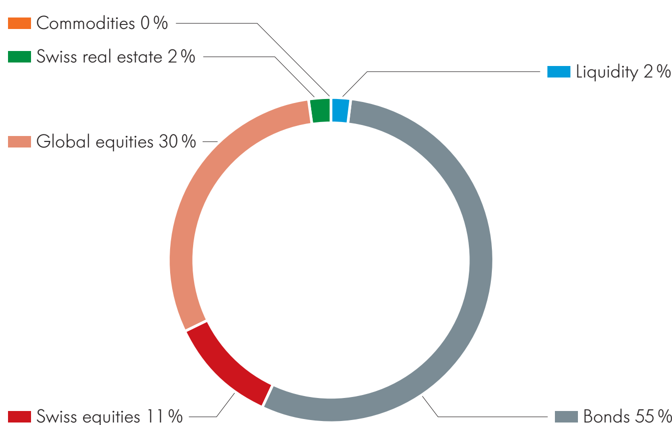
Exploit opportunities in Switzerland

In the environment outlined above, Swiss equities can be expected to outperform their European counterparts. The Swiss market contains a good mix of less cyclically-dependent stocks on the one hand and structural growth plays on the other. The latter include stocks from the medtech sector, for example. Furthermore, manufacturing – and notably the automation segment – has potential for structural growth. Swiss companies tend to be globally diversified, and many of them generate a substantial proportion of their revenues in the US and Japan. Thanks to the high quality of their business models, many Swiss companies are exploiting their price-setting power and generating attractive cash flows – and are therefore impressing the capital market. Swiss equities retain their high portfolio weighting, accounting for a third of our entire equity allocation.

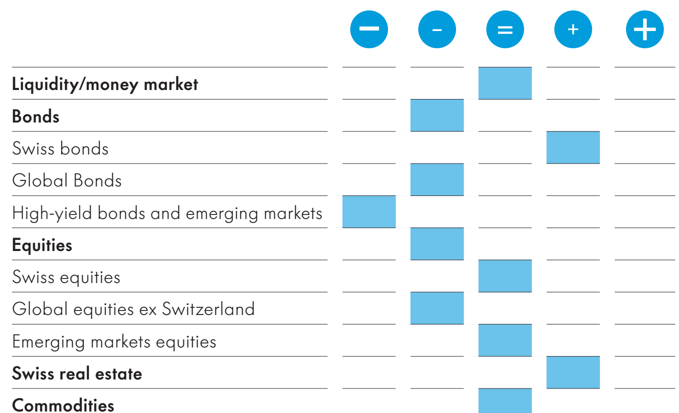
Use bonds judiciously

In the fixed-income asset class, we prefer Swiss corporate bonds as they offer an attractive current yield. In addition, US government bonds are a useful tool for portfolio hedging purposes. Price gains are likely here if capital market interest rates fall due to economic developments and lower inflation.

Strategic positioning (based on balanced mandate)



Tactical positioning



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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