Zuger Kantonalbank

Portfolio

July 2023

Market overview and positioning

US technology stocks have soared in recent weeks. By contrast, equity markets as a whole have trended sideways. The focus now is on the increasingly pronounced economic downturn and its impact on companies. Inflation rates are still too high, central banks remain hawkish.

Downturn accentuated

We are looking ahead to the second half of 2023 with cautious optimism. Inflation is trending in the right direction, but restrictive monetary policy is weighing on the economy. Higher interest rates and weaker economic growth are shaping the investment environment. For now, disruptive geopolitical factors have receded into the background somewhat. We believe we are in the late phase of the growth cycle. Our base scenario therefore predicts a growth slowdown and the normalisation of inflation rates.

Corporate sector financially sound

Thanks to its robust constitution, the real economy has proved resilient so far. This is attributable to a high level of savings and the interplay of wages and inflation. The European and US labour markets are strong, and unemployment rates are low. Employees are now using wage negotiations to claw back a proportion of their lost purchasing power, hence wages are rising. This is propping up consumer sentiment. So far, companies have managed to pass on higher production costs. But the first cracks are appearing – many European companies have issued profit warnings. This mix points to an eventful reporting season, and predicting its outcome looks challenging.

Key interest rates remain high

After what has proved the most rapid rate-hiking cycle for decades, a plateau phase is in sight, at least in the US. We are expecting interest rates to remain at elevated levels for the rest of 2023. Interest rate cuts are unlikely, as any premature loosening of monetary policy harbours the risk of much higher inflation in the next economic upturn. Moreover, we are expecting the Fed to keep US interest rates high, despite falling rates of inflation, weakening economic momentum and turbulence in the banking sector. Indeed, a further rise is in the offing.

SNB inflation target reached

Yet again, Switzerland looks to be a special case. Inflation declined to 1.7% in June 2023 (previous month: 2.2%), bringing it below both the market's expectations and the inflation target bandwidth of the Swiss National Bank. The core inflation rate (which excludes energy costs) also declined, from 1.9% to 1.8%.

"Inflation in Switzerland is already falling below 2%. But it would be premature to 'sound the all clear'. The SNB will not be abandoning its vigilant stance."

Alex Müller, Chief Investment Officer

Market overview and positioning

This makes Switzerland the first country to report both its overall rate of inflation and its core rate falling below the 2% mark. Nonetheless, we are expecting the SNB to push through another rate increase in the autumn. The current low-inflation phase will prove only temporary, as rents will be rising from the autumn onwards due to the higher reference interest rate and landlords passing on higher costs. Many officially administered prices will also rise from January 2024, as will the rate of VAT. All this will coincide with a lower price base than in the first half of 2022, which will prompt the SNB to resort to further rate hikes.

Focus on Swiss bonds

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 expectations for economic development, bonds serve as a stabilising element in portfolios with equity exposure thanks to the diversification they offer. Within this asset class we prefer Swiss corporate bonds, which offer an appealing yield of 2%. Although this is lower than the yield on comparable debt from other counties, Swiss franc-based investors avoid the currency risks.

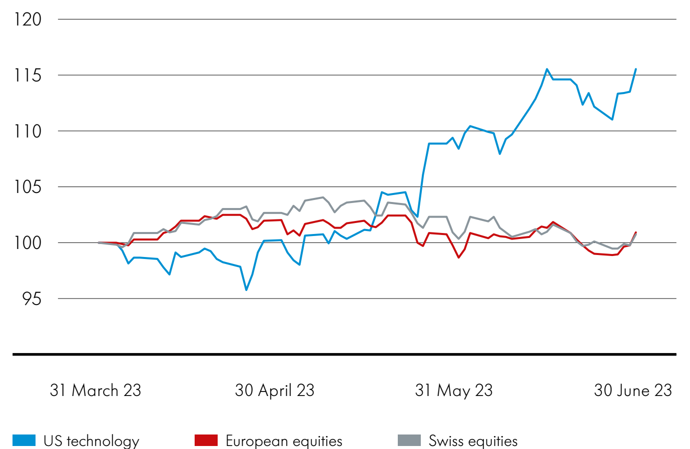
"US technology stocks cannot be ignored – the structural AI boom looks set to persist. For low-quality corporate bonds, caution is advised as the risk premium is too low."

Alex Müller, Chief Investment Officer

Equity volatility

We are expecting the rapid rises in key interest rates in the US and in Europe to increasingly feed through into the real economy. Higher financing costs will depress corporate investment and weigh on economic growth. This will increase uncertainty over the development of corporate earnings. In our view, the risk of declining corporate profitability is insufficiently reflected in the corresponding forecasts and stock market 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 would fuel hopes of prompt cuts in key rates, which should in turn lend support to equity markets. Given these opposing tensions, we are expecting heightened equity market volatility in the second half of the year, but we remain invested and are maintaining our defensive equity positioning.

US technology stocks and European equities – a comparison



Source: MSCI

Bonds have greater potential

In the current environment, we recommend that investors give bond investments a greater weighting than equities. Current yields are attractive thanks to higher interest rates, while in addition the hedging function of bonds should once again prove effective. Within this category, we prefer government bonds and are reticent about corporate borrowers of low quality. As long as there is no further slowdown in economic momentum, greater equity exposure then looks to be the right approach as the year progresses.

Staying invested has paid off

The end of the rate-hiking cycle appears to be close. But growth fears remain. In the event of inflation rates coming down, hopes of lower key interest rates will once again give a boost to equity markets. These opposing tensions have yet to be resolved. So remain invested – the first half of 2023 once again underscored the validity of this stock market adage. A solid and broadly diversified investment strategy is the best recipe for generating decent returns in such an environment.

What does this mean for investors?

Boom theme: artificial intelligence

We have increased our exposure to US equities in the portfolios. The reason for this is the unexpectedly strong boost coming from the potential of artificial intelligence (AI). Despite high and in some cases exaggerated valuations, we see a good chance that the extraordinary momentum in the US technology sector will continue. In addition to the massively hyped Nvidia, cloud service providers and companies from the semiconductor industry could benefit from the huge potential of AI going forward.

Market driven by just a few stocks

The US tech segment aside, our equity positioning remains underweight. Neither the European nor the Swiss equity market benefited from the AI boom in the second quarter (see chart). Both markets stagnated in the face of economic reality: a greater probability of recession, record levels of market volatility, weak momentum from China and poor market breadth are all arguments for caution. In our view, investors would be best served by maintaining a defensive stance for the time being.

Europe looks cheap

In particular, our underweight equity stance relates to the developed nations and Europe (excluding Switzerland). Although valuations, particularly in Europe, are essentially a positive argument for these equity markets, we are concerned about the lack of momentum, as well as the sharp downturn in economic dynamism in China after the economy. An economic slowdown is evident in Europe too, as is clear from the profit warnings issued by a number of companies. What's more, the European Central Bank (ECB) is likely to raise interest rates further, which will weigh even more heavily on what are already high risk premiums.

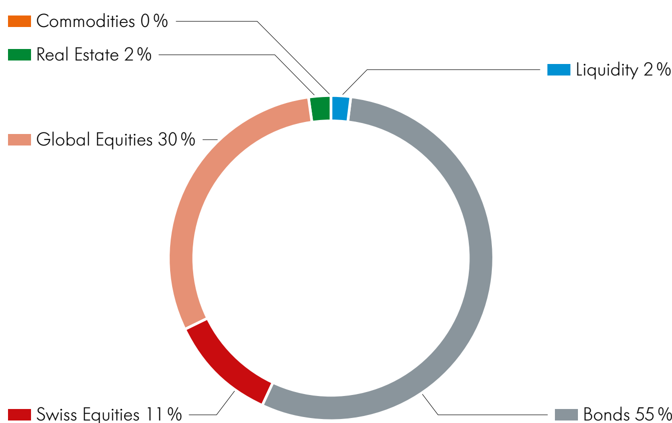
Defensive Swiss quality

Thanks to the high quality of their business models, many Swiss companies are exploiting their price-setting power, generating attractive cash flows and impressing the investor community. Swiss equities retain their high weighting, accounting for a third of the entire equity allocation. The defensive mix of sectors can be expected to work to the investor's advantage in the likely difficult environment of the coming months – more so than in the quarter just ended.

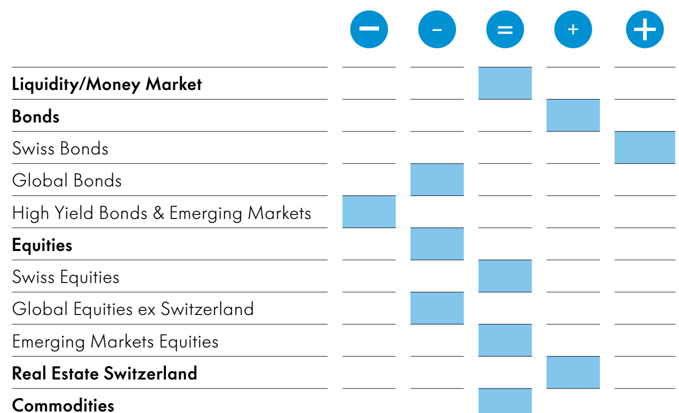
Convincing arguments for Swiss real estate

We recommend an unchanged positioning in Swiss real estate. Although this asset category experienced another correction at the end of June, the valuation levels of Swiss real estate funds are attractive both from a historical standpoint and in view of the current level of interest rates. The higher reference interest rate will result in higher rental income, hence the cash flows of such investments will 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.

Strategic Allocation (Source Balanced Mandate)



Tactical Allocation



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Liquidity/Money Market			■		
Bonds				■	
Swiss Bonds					■
Global 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 on the current portfolio?

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

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