Review & outlook

January 2023

Review of 2022

A perfect storm

The 2022 investment year was truly challenging for investors. Three themes dominated the financial markets: the war in Ukraine, rising rates of inflation globally and, as a consequence, a more restrictive monetary policy stance on the part of central banks. This in turn led to sharp rises in capital market interest rates, which weighed hugely on secure fixed-income investments such as government bonds. At the same time, uncertainty grew over the future development of the economy. This in turn resulted in a widening of bond credit spreads, which represented an additional weight on corporate bond investments of both good and poor quality.

The great sell-off

Equities also suffered in this environment, however. The strong simultaneous sell-off of all asset classes – commodities aside – was a defining feature of 2022. The loss on a balanced portfolio comprising 60 % equities and 40 % bonds was quite unprecedented. Both defensively and dynamically structured portfolios suffered similarly huge losses.

Ukraine war acts as a drag

On 24 February 2022, Russia launched a war of aggression against Ukraine. This day marked a turning point in many respects. The West took Ukraine's side and supplied the country with copious quantities of weaponry. In a move that saw Europe close ranks against the aggressor, Finland and Sweden formally applied to join NATO. The conflict brought home Europe's dependency on Russian natural gas and weighed on global optimism generally.

War and pandemic drive up prices

The war and the associated sanctions against Russia resulted in the prices of all sorts of goods rising, on top of the increases already seen during the COVID pandemic. Energy and agricultural commodities, palladium, platinum, intermediate products for the semiconductor and automotive industries – and much more besides – became even more expensive. Meanwhile, China's strict zero-COVID strategy with its relentless lockdowns exacerbated the situation. Even after the Communist Party Conference in October, no definitive move away from the rigorous zero-COVID strategy became apparent. Accordingly, the factors that had been driving prices up in 2021 turned out to be anything but "temporary", despite central banks having repeatedly argued just that.

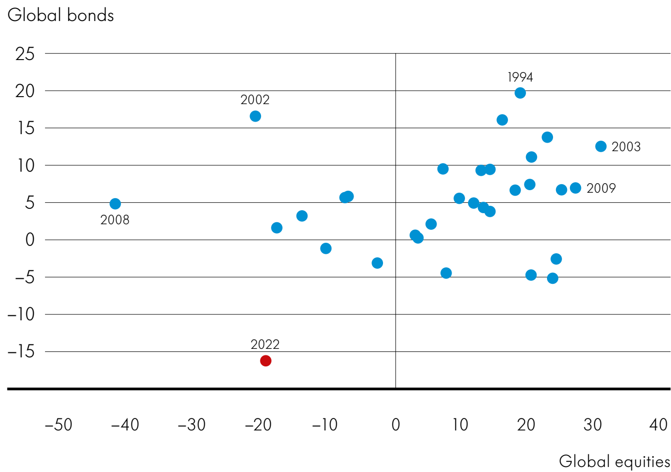
"Rising interest rates and falling equity prices dominated large parts of an extraordinarily difficult year for investors. Global developments were shaped by high inflation – exacerbated by the war in Ukraine – and the knock-on effects of the pandemic."

Alex Müller, Chief Investment Officer

Fed leads the way

Central banks responded to the situation late but energetically. In the United States, the Fed initiated the process of monetary tightening in March and has since raised its key interest rate seven times to a current level of 4.5 %. Although the US labour market proved strong, economic momentum weakened markedly compared to the previous year.

Performance equities vs. bonds (in percent)



The ECB's dilemma

It was not until July that the European Central Bank (ECB) abandoned its policy of negative interest rates. While record high inflation called for decisive action, the Ukraine war and waning economic dynamism were arguments for a more dovish approach. The most recent interest rate step taken by the ECB was a rise of 50 basis points in December. But with inflation rates still in double-digit territory in the member states of the Eurozone, the ECB policy-makers continue to face a dilemma.

SNB underlines its independence

Under the stewardship of Thomas Jordan, the Swiss National Bank acted before the ECB in the early summer, thereby impressively demonstrating its independence in the battle against inflation. Thanks to a strong Swiss franc, Switzerland experienced a lower level of price pressure than its neighbours over the course of 2022. This difference in inflation had the effect of reducing the overvaluation of the franc.

Equity markets fall back from record highs

2022 will go down as a bad year for global equity markets. This is primarily attributable to valuation corrections in the face of higher interest rates. But something else sticks out too: Despite the energy crisis, the war in Ukraine, inflation and higher interest rates, company results held up relatively well. In the US, almost 60 % of companies surpassed expectations on the sales front in the third quarter, with the equivalent figure for profit being as much as 70 %. This no doubt prevented equities from suffering even greater losses.

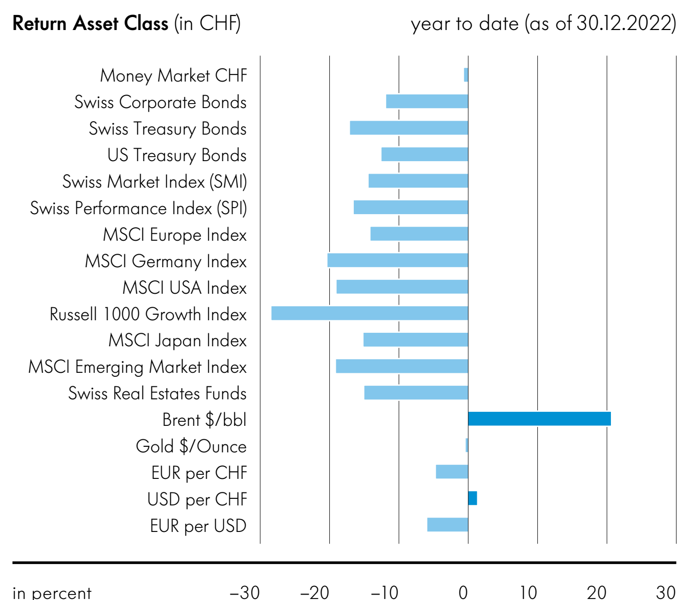
Bonds fail to offer protection

Fixed-income investments suffered from higher capital market interest rates. Widening credit spreads weighed on corporate bonds, and even the more security-oriented investments experienced significant reverses in the first half of the year. In keeping with these book losses, yields to maturity drifted up continuously from their previous levels of around zero. The appeal of bonds therefore increased sharply over the year as a whole.

Things calm down on the geopolitical front

The geopolitical situation became less tense towards the end of the year under review. The mid-term elections in the US unfolded without triggering any major dislocations. The energy crisis lost something of its severity thanks to well-filled gas storage facilities and a prolonged spell of mild weather in Europe. Global supply chain shortages are no longer proving such a problem. What's more, Russia appears to be isolated on the world stage in the Ukraine war, while the Ukrainian army has been regaining territory. The suffering of the Ukrainian population is likely to worsen over the coming winter. There is still no sign at the start of the new year that the Russian army might be planning a broad-based withdrawal. What remains of this investment year, and where do we see the possible opportunities for 2023?

Return Asset Class (in CHF) year to date (as of 30.12.2022)



Outlook for 2023

How bad will the downturn be?

Despite improvements on the geopolitical and inflationary fronts, the fundamental outlook is not that rosy. The extent of the expected downturn will be largely determined by two factors: the economy and inflationary developments. Monetary policy is also set to be heavily shaped by these two factors. Our base scenario predicts a further growth slowdown and gradually normalising rates of inflation. This is an argument for remaining invested and actively adjusting the portfolio structure. Bonds once again present opportunities, while equities can be expected to gain in appeal as the year unfolds.

Growth slows sharply

The leading economic indicators have deteriorated further over the last few months. They have been mediocre in the US, tending to track downwards. In Europe, the Ukraine war is weighing on sentiment, as is persistently high inflation against the backdrop of a weak euro and high energy prices. Corporate earnings can be expected to decline against a backdrop of slower sales growth and lower margins.

Inflation has probably peaked

Whereas inflation rates in the Eurozone remained stubbornly above 10 % in November, a slow but gradual decline from a high level has become apparent in the US. In a year-on-year comparison, the rate of price increases recorded a decline for the fifth month in succession to 7.1 %, which is of course still very high in absolute terms. The US inflation rate rose by 0.1 % in November, which was less than expected. Accordingly, the rate of inflation appears to have already passed its peak, at least in the US.

The last major interest rate rise

Despite this, the Fed pressed ahead with its monetary tightening. In December it pushed up its key rate once again, namely by a further half a percentage point to 4.5 %. This was the seventh interest rate hike since March. Although we do not believe this is the last rise from the Fed, the peak should be reached soon.

Central banks maintain hawkish stance

From today's standpoint, however, we believe it is too early to anticipate a change in the monetary policy course of central banks. We are not expecting them to counteract the impending downturn rapidly and decisively. The guardians of monetary policy, above all in the US, are unlikely to deviate from their hawkish course for the foreseeable future.

Bonds are back

In our portfolios, bonds currently have a higher weighting than in the defined investment strategy. In view of higher interest rates and a marked slowdown in growth, they are more attractive than equities when viewed in relative terms. We are convinced that the diversification properties of bonds will once again kick in, generating higher current yields for investors.

Mix looks to be the way forward

Where fixed-income investments are concerned, corporate bonds are appealing. Here we like Swiss bonds but are also recommending global (but currency-hedged) exposure. Government bonds also have a place in the portfolio, as they should provide a defensive element in the event of a sharp market downturn. Swiss real estate investments appeal as a further portfolio element.

> "We are looking optimistically into the 2023 investment year: In the first half, the repercussions of restrictive monetary policy for the economy and corporate earnings will remain the focus of investors. Bonds are attractive, and equity investments will enjoy a comeback in 2023."
>
> Alex Müller, Chief Investment Officer

Recession or no recession?

Where the equity quota is concerned, we recommend sticking with an underweight stance as the new investment year gets underway. The development of equity markets going forward will be overwhelmingly driven by the prospects for the global economy. The difficulty of calling a recession from today's standpoint is a source of uncertainty. But as of yet there has been no broad-based decline in corporate earnings.

Brighter horizons as the year unfolds

In the coming year, companies will no longer find it so easy to push through price increases. We consider the market's expectation that corporate earnings will develop stably in 2023 to be unjustified. This said, given the current forecasts for inflation and monetary policy, the market environment for equities should improve as the year unfolds.

Quality stocks matter

Equities therefore remain an important component of any portfolio. Portfolios should include structurally strong sectors, defensive plays and above all quality stocks that can maintain stable margins even in difficult times. Stock selection should be based on whether companies can confirm their earnings expectations or whether a downgrade is on the cards.

Swiss equities appeal

Swiss stocks remain heavily weighted, accounting for a third of the entire equity quota. The defensive sector mix is a positive factor here. Thanks to their convincing business models, Swiss companies have considerable price-setting power. They generate attractive cash flows and high returns on capital. As a result, they should be able to cope well with the challenges of a weakening global economy.

Ready for the upturn

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, and their hedging function should once again prove effective. As long as there is no further slowdown in economic momentum, greater equity exposure then looks to be right approach as the year progresses.

A sustainable portfolio

With effect from January 2023, Zuger Kantonalbank will be applying sustainability criteria to its bond, fund and asset management mandates. Further sustainable investment products are planned for the second half of the year. Your advisor will be pleased to explain what this means for you upon request. You can find further information on the theme of sustainability and ESG on our website.

Diversification will pay off

The end of the rate-hiking cycle is not yet in sight, which means growth fears will persist for a while yet. In the event of inflation rates coming down, hopes of lower key interest rates will once again give a boost to equity markets. These two aspects will continue to dictate market developments in 2023. So our advice for the new year is as follows: Remain invested. A broadly diversified investment strategy is the best recipe for success.

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