Zuger Kantonalbank

Review & outlook

January 2024

Review of 2023

Positive start

The first half of 2023 surprised on the positive side, particularly after the challenges faced by stock markets in 2022. Despite uncertainties as a result of geopolitical tensions and economic imponderables, global financial markets proved to be remarkably robust. In particular, equity markets demonstrated astonishing resilience. The opening-up of China following the COVID pandemic provided additional positive stimuli at the start of the year. In short, investors attached greater importance to the long-term growth outlook than to the prevailing short-term risks.

Strong corporate sector

This stance was primarily attributable to the fact that most companies unveiled strong results. Companies showed themselves to be impressively robust, and adapted effectively to changed market parameters – specifically the interest rate and inflation environment. This adaptability fuelled markets with confidence and pushed up the values of mixed portfolios.

Bankruptcies in banking sector as acid test

But this positive sentiment was put to a severe test as early as the spring. Tremors in the banking sector, most notably the collapse of Silicon Valley Bank in the USA and the ensuing demise of Credit Suisse as an independent entity, were two unmissable flashing red beacons. But financial markets maintained their stability despite these challenges. This showed how much more confidence market participants had in the stability of the financial system compared to the financial crisis of 2008/09, and testified to the effectiveness of the measures taken in the meantime. The resolute and prompt intervention of central banks played a decisive role in ensuring market stability.

"For much of the year, 2023 was characterised by a volatile investment environment. It was another challenging year for investors. Rising interest rates had a conflicting impact on bond investments. US technology stocks dominated global equity markets."

Alex Müller, Chief Investment Officer

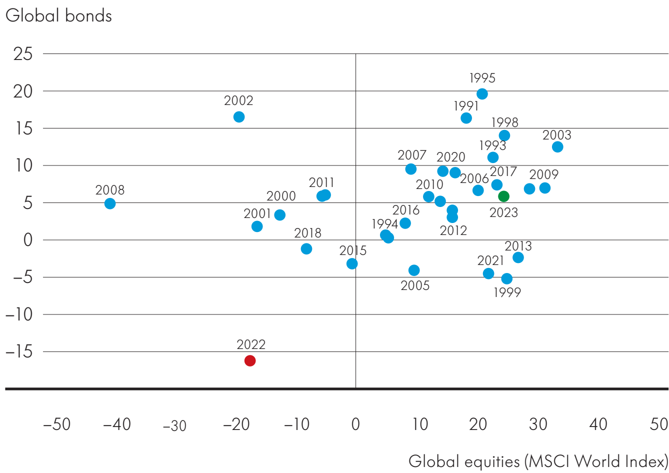
Tighter monetary policy

Tighter monetary policy all around the world – particularly in the US and Europe – ushered in a new phase in the economic cycle. Central banks, which had to walk the tightrope of taming inflation without excessively throttling growth, played a crucial role in shaping the market environment. No less than eleven interest rate rises by the US central bank (Fed) from the spring of 2022 onwards, together with multiple rate hikes on the part of the European Central Bank (ECB) too, sent out clear signals. In the second half of the year, financial markets were exposed to opposing influences, with the economy weakening due to higher interest rates on the one hand but rates of inflation falling steadily on the other.

Inflation curbed

Inflation – one of the major headaches of 2022 – embarked on a downward trajectory in both the US and Europe in 2023. While this proved the effectiveness of the monetary policy measures taken, it was also the result of an improvement in the functioning of global supply chains and base effects in connection with commodity prices. The result of all this was greater confidence in the economy. Fears of an uncontrolled inflationary spiral were dissipated.

Performance equities vs. bonds (in percent)



Switzerland gets inflation under control

The situation was similar in Switzerland. At the start of the year, the Swiss National Bank (SNB) was confronted with an inflation rate that was greater than its target figure of 2%. It responded with a total of five rate hikes in order to restore price stability. By November 2023 inflation had come down to 1.4%, well within the SNB's target bandwidth. This is a noteworthy success, and one that sets Switzerland apart from other developed economies. As the year progressed, the strong Swiss franc was particularly helpful in alleviating imported inflation in connection with higher commodity prices.

Equity markets on song

Against this backdrop, the US and European stock markets in particular delivered handsome returns, even though higher interest rates and lower growth expectations made for a volatile environment. Many companies were successful in passing on higher input costs, thereby preserving their profit margins. This confirms our investment focus: We prefer companies whose operating efficiency and price-setting power enables them to perform well even in an uncertain economic environment.

Boom in US tech shares

The real driver of equity market performance last year was the technology sector, particularly in the US. The stocks of these companies surged despite rising interest rates. This reflects a differentiating stance on the part of the market, which views the tech sector as the leading force for innovation and growth.

Bonds have a mixed year

Bond markets likewise experienced a dynamic year. Despite higher volatility, a number of segments – particularly Swiss corporate bonds – delivered attractive returns. The diversification characteristics of bonds continue to play a key role in investment portfolios, especially at times of heightened uncertainty and market volatility.

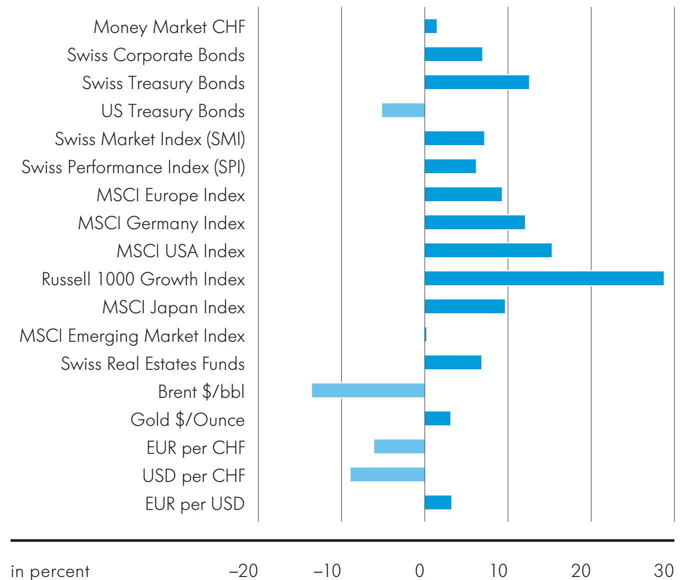
Have interest rates peaked?

Although inflation rates were falling perceptibly, they persisted throughout the year at a level that forced central banks all around the world to remain restrictive. Towards the end of the year, however, the markets reached a broad consensus that the interest rate peak has probably been reached. Monetary policy looks sufficiently restrictive to achieve its objectives.

Growth cools

In the fourth quarter, the results of the leading economic indicators in the US proved to be rather mixed, with a negative tendency if anything. European sentiment meanwhile was dragged down by the war in Ukraine, economic weakness in China, political squabbles in Germany and high energy costs. In Switzerland, it was above all manufacturers that felt the weakness emanating from Europe. Will 2024 bring a recession?

Return Asset Class (in CHF) year to date (as of 30.12.2023)



Outlook for 2024

Soft landing the base scenario

The global economy should grow in 2024 but at a modest rate. This is our basic assumption. In other words, we are expecting neither a pronounced recession nor another significant acceleration in growth. Political parameters are acting as a headwind. In both the US and Europe, fiscal support is likely to be more restrictive than it was in 2023. Accordingly, the extremely impressive real growth figures recorded by the US economy in recent quarters are very unlikely to prove sustainable. In addition, monetary policy can be expected to remain restrictive for the time being: Other than in Switzerland, inflation rates remain above their target bandwidths, and labour markets are robust. Central banks will be wary of potential second-round effects.

> "2024 presents opportunities for mixed investment portfolios: government bonds offer protection against the economic downturn, equities should become increasingly attractive as the year develops."
>
> Alex Müller, Chief Investment Officer

Consumer spending as prop

At the same time, various factors point to the unlikelihood of a severe downturn. The economy continues to gain support from strong balance sheets in the corporate sector. Savings rates remain high in Europe, while in the US households still have hefty cash holdings. The strong labour market is shoring up consumer confidence. The wage increases of the last two years will provide a strong basis for spending for the time being. That said, consumers can be expected to become more circumspect. Rising credit costs, more rigorous lending guidelines and higher energy prices are eroding their financial flexibility.

Artificial intelligence as booster

The possibilities of artificial intelligence (AI) are providing an unexpectedly strong boost to equity markets. Chip manufacturer Nvidia unveiled almost impossibly good results in 2023. Other companies from the semiconductor sector as well as cloud service providers should likewise benefit from the enormous potential of AI in the future. US technology stocks were the key driver of stock market performance in 2023.

Geopolitical situation remains tense

It is a generally accepted wisdom that (geo-)politically-driven market movements are short-lived. Markets typically recover after dislocations caused by political events. However, the geopolitical conflicts currently unfolding appear to be more complex than many previous ones. Domestic politics will also be a focus of financial markets in 2024. In the Eurozone, Germany in particular is inward-looking right now. The current government lacks not just support for its agenda, but also the money to implement it. At the same time, the major source of stimulus for global export activity – China – is faltering.

Will the US elections prove a turning point?

The impending elections in the US could recalibrate the geopolitical priorities of this superpower. The backdrop of all this is major conflict in both the Middle East and the Ukraine, with the US also involved militarily in both theatres, albeit indirectly. 2024 could therefore turn out to be a watershed year for Ukraine. China currently appears to be preoccupied by internal challenges, but competition with the US is likely to create plenty of background noise next year too.

A look at Switzerland

Switzerland has not been immune to international developments. Here too, the leading economic indicators are currently experiencing a weak phase. Together with the low level of inflation, this suggests that interest rates have peaked. However, higher rents and an increase in administered prices such as VAT could bring about another slight rise in the rate of inflation.

Mixed portfolios have potential

The last two years have been challenging for investors in mixed portfolios. Equity investors were clearly compensated for the risk they took on in 2023, albeit with a fair amount of accompanying volatility. The results of mixed investment vehicles look rather different. Certain equity segments and regions enjoyed significant gains in 2023, but higher interest rates clearly limited their upside potential.

International bonds are back

As things stand, government bonds from both the US and Europe have a high weighting in our portfolios. These investments are attractive given the higher absolute level of interest rates of these regions compared to Switzerland and the expected growth slowdown. We are convinced that the diversification properties of bonds will be more keenly felt in 2024 and generate higher current yields for investors.

A broad mix the order of the day

Where bond investments are concerned, we continue to recommend high-quality corporate bonds. Here we like both Swiss paper and global (but currency-hedged) exposure. Swiss real estate investments have appeal as a further portfolio element.

Remain true to approach and domestic market

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

European equities look cheap

As the year gets under way, we continue to recommend the underweighting of European equities. Economic headwinds have strengthened in the Eurozone. Otherwise the opportunities and risks of equities look to be balanced – along as there is no significant deterioration in the economic environment. European equities can be expected to gain in appeal as the year progresses. Given the current uncertainties, they are now very cheaply valued.

So our advice for the new year is as follows: Remain invested. A robust and broadly diversified investment strategy is the best recipe for success.

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