Review & outlook

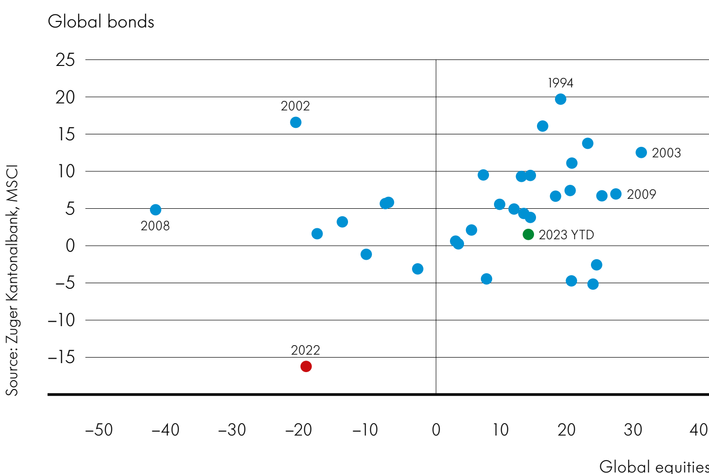
July 2023

Review of the first half of 2023

An unexpectedly strong first half

After a very disappointing 2022 for investors, we initially expected a calming of the market situation. We expected headwinds above all on the equity front, where the focus was on the weaker economy and inflationary developments. As expected, the new restrictive monetary policy environment made itself felt on the real economy. The financial markets – and above all equity markets – managed to shrug this off to some extent, with the result that a mixed portfolio gained in value. This was particularly due to the way companies performed in the difficult environment. Which now begs the question: Has the hurricane passed through the financial markets, or are we in the eye of the storm?

Performance equities vs. bonds (in percent)



Development of inflation as catalyst

Inflation developed encouragingly in the first half of 2023. In the US, it declined slowly but steadily from a high level. In the Eurozone too, the inflation rate declined steadily from its peak level of more than 10 % recorded in November 2022. In April it still stood at 7.0 % – still a high level, but the trend is in the right direction. That said, it is likely to be a while yet before inflation is back within the target bandwidth of the European Central Bank (ECB) – i.e. below 2 % – and the Fed.

Switzerland's special situation

In Switzerland too, things are going the right way. In a year-on-year comparison, Switzerland's inflation rate recorded a decline to 2.2 % in May, a notable improvement on the 2.6 % recorded for April. Not since before the start of the war in Ukraine have Switzerland's inflation figures been this low. Nonetheless, inflation remains above the SNB's target level of 2 %, and its downward trajectory will not be helped by the rise in the reference interest rate and higher rents in the wake of the requested cost-of-living adjustments. Against this backdrop, the SNB increased its key rate by a further 0.25 % on 22 June. This now stands at 1.75 %. The next few quarters will reveal whether this latest rate hike can slow the rise of prices in Switzerland.

"Our fundamentally constructive expectations for the first half of the year proved correct. Mixed investment portfolios clawed back some of the losses of the previous year. Equities developed positively, with US technology stocks leading the way."

Alex Müller, Chief Investment Officer

Tighter monetary policy

The first half of 2023 saw the world's developed economies tighten monetary policy significantly. In the US, a total of ten interest rate moves since the spring of 2022 has resulted in the relevant key rate rising to its current level of 5.25%. In Europe too, the ECB tightened the interest rate screws having initially shown some hesitancy. To start with, market participants doubted whether the more punitive financing conditions that this entailed would feed through into the real economy. And indeed, consumer spending remains strong, which is probably due to a combination of the catch-up effect – particularly in the services sector – following the lifting of the COVID containment measures and a very strong labour market.

Tremors in the banking sector

However, in the spring of 2023 the dislocations expected in the wake of the rapid implementation of highly restrictive monetary policy duly manifested themselves. Following on from the downfall of Silicon Valley Bank in California, Credit Suisse had to throw itself into the protective embrace of its biggest rival. The reasons for the demise of these two banks were specific and home-made – and involved errors made over many years. That said, the swift rise in interest rates hastened and ultimately sealed the fate of these institutions. Although a number of other regional banks found themselves in trouble, this did not affect the development of the financial markets.

Solid foundations

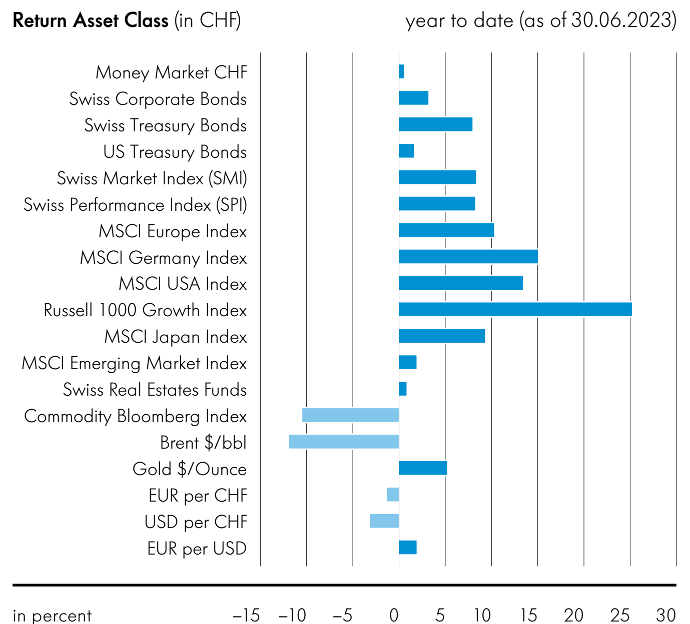
Confidence swiftly returned to the capital markets. Through their vigorous intervention, central banks guaranteed the stability of markets. Furthermore, both regulatory authorities and the media made it clear that the banks – particularly in Europe – are now better capitalised than during the financial crisis of 2008/2009. However, this confidence could yet prove misplaced.

US markets post gains

Over the last few months, investors have enjoyed pleasing returns on their equity market holdings, despite the banking crisis and deteriorating expectations of economic development. In the US, many parameters look favourable: inflation rates have receded slowly but steadily, consumers have continued to open their wallets despite higher prices, and the healthy overall picture is rounded off by an attractive labour market and real wage increases. In a surprising development, corporate earnings have proved relatively stable.

Europe and Switzerland look strong

Just like the European markets, the Swiss equity market has also benefited from improved sentiment. In particular, the end to China's zero-COVID strategy has provided stimulus to cyclical stocks. The confidence of the investment community has been buoyed by the potential for catch-up spending in China. Investors in both the Swiss and European stock markets recorded healthy gains.



Source: SIX, Zuger Kantonalbank, MSCI, Russell, Bloomberg

Bonds are back

While the equity markets saw remarkably little in the way of market fluctuations in the first half of the year, bond markets experienced a more volatile environment. Our stronger focus on Swiss franc-denominated bonds paid off. This segment delivered the best returns in the first half of the year. We are convinced that the diversification characteristics of bonds will continue to benefit investors, who are looking at the prospect of higher current yields.

Outlook for the second half of 2023

How bad will the downturn be?

Disruptive geopolitical factors have receded into the background somewhat in recent months, and the development of inflation is on the right trajectory. Nonetheless, this environment continues to call for caution. We believe we are in the late phase of the growth cycle. Any renewed acceleration of growth will not be sustainable. Our base scenario therefore predicts a further growth slowdown and the ongoing normalisation of inflation rates.

Corporate sector financially solid

Up until now, the private sector has exhibited considerable resilience thanks to its relatively strong constitution. This is founded on a high level of savings and the interplay of wages and inflation. The European and US labour markets are tight, while unemployment rates are low. As a consequence, employees are clawing back in wage negotiations a proportion of the loss in purchasing power they have suffered over the last two years, and hence wages are rising. This has buoyed the mood of consumers, while at the same time companies have so far been successful in passing on higher input costs.

> "We are looking to the second half of 2023 with cautious optimism: inflation is continuing to fall, restrictive monetary policy is slowing the economy. Higher interest rates and weak economic growth are shaping the investment environment."
>
> Alex Müller, Chief Investment Officer

Key interest rates remain elevated

Following what has turned out to be the most rapid cycle of interest rate increases for decades, a plateau phase is now 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. 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.

Bonds once again makes sense

With their ongoing income streams, bonds are once again making a key contribution to the return on an investment portfolio. In the current environment, we consider bonds to be just as appealing as equities. Within this asset category we prefer Swiss corporate bonds, which offer an attractive yield of 2%. Although this is slightly lower than the yields offered by their foreign counterparts, it means that the investor need not worry about relatively expensive currency hedging. In keeping with our expectations for economic development, Swiss bonds also serve as a stabilising element in portfolios with equity exposure thanks to the diversification they offer. We have accentuated this aspect as part of the review of our investment strategies. In the mixed mandates, the design of the portfolios therefore takes greater account of fundamental changes in the interest rate environment. Swiss bonds have a higher weighting in the portfolio, while the cash allocation has been reduced.

Equity volatility

We are expecting the rapid increases in key interest rates in the US and Europe to in-creasingly 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 in turn would feed hopes of imminent cuts to key interest rates and lend support to equity markets. Given these opposing tensions, we are expecting heightened equity market volatility in the second half of the year and are sticking to our defensive positioning.

Real estate looks solid

We continue to recommend the overweighting of listed Swiss real estate funds. In the first quarter of 2023, premiums declined to an average of 10 %, which means valuations are now sufficiently reflective of the changed interest rate environment. Real estate funds are once again offering a distribution yield of just under 3 %, while at the same time offering some protection against inflation. The rise of the reference interest rate to 1.5 % in June 2023 enables landlords to increase rents by up to 3 %. Furthermore, 40 % of inflation and general cost increases can be passed onto tenants. Market rents are also likely to be pushed up by the persistent scarcity of vacant housing, the pressure of net migration and declining construction activity.

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. The question of whether we are currently in the eye of the storm cannot be definitively answered from today's standpoint. Even if the worst of the hurricane is already likely to have passed, we are still expecting sporadic powerful gusts. Monetary policy plays out slowly, and with a time lag, so any knock-on effects are only likely to become apparent over the next few quarters. This remains an argument for maintaining a broadly diversified portfolio.

Staying invested has proved worthwhile

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 in-vested – the first half of 2023 has once again underscored the validity of this stock market adage. A solid and broadly diversified investment strategy is the best recipe for generat-ing decent returns in such an environment.

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