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Vontobel

US Investors' Outlook

Eyes on the end zone

March 2024

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Eyes on the end zone

—
Dr. Pascal Köppel
Chief Investment Officer,
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Dear readers,

The macro environment got off to a much better start than originally expected by many market participants. US economic performance, in particular, stands out. Firstly, the growth reported for Q4 was strong. Secondly, the US labor market continues to produce solid employment growth numbers and thirdly, inflation has not come down as fast as many had hoped. This has led to a repricing of Fed funds rate expectations by financial markets, which has supported the US dollar versus other currencies. The market is expecting less than 90 basis points in Fed interest rate cuts for the whole of 2024 now. We think that the market premise of central bank action this year looks a lot more realistic.

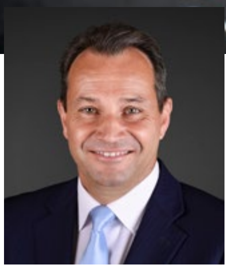
Macro data is not the only factor causing more moderate expectations of Fed rate cuts. The Fed itself is a contributing element too. After rate cuts were priced in heavily at the end of 2023 and against a positive flow of economic data, the Fed started to push back against the markets expecting too much too soon. And it was not just the Fed, the ECB too indicated that rate cuts are not yet up for discussion.

Central banks are not in a hurry to end their tight monetary policy, given the risk that inflation could accelerate again. The Fed can certainly afford to be patient, given the more than decent macro backdrop. That said, we do think that a normalization of inflation will provide both the Fed and ECB with the opportunity to start reducing rates. However, this is likely towards the end of Q2.

The downside risks to US growth are clearly easing further. Although a US or global recession was never our base case, the probability of a global hard landing risk scenario is receding further. Some countries have gone through more difficult economic circumstances with virtually no GDP expansion during 2023. The euro area and the UK are examples of that. At the same time, China is still struggling with a real estate crisis and deflation risks. More importantly, forward looking indicators are providing evidence that economic momentum is turning for the better, on a global as well as on a European level.

In our base case, we see relatively robust global growth and moderating inflation. This is a positive environment for riskier assets. It calls for a more balanced overall stance on tactical asset allocation. At our last Investment Committee meeting, we decided to upgrade European equities, as we believe that notoriously unloved eurozone stocks may be poised for a recovery as the year progresses. We are also holding on to an overweight in Switzerland, while being underweight in the UK. The European upgrade has changed our overall position in equities from neutral to a medium overweight. We continue to like fixed income, because of attractive overall yield levels and the potential for lower yields this year, helped by moderating inflation and central bank easing. At the same time, high-quality fixed income is an attractive diversifier in case of an unexpected growth setback. The same holds for gold, which we continue to overweight.

While the rate cuts may not be as soon or as large as many investors had hoped, we are keeping our eyes on the end zone.



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The global economic outlook has become more constructive for risky assets

Declining downside risks to US economic growth combined with signs of improving global economic momentum, at least in developed markets, is generally sending out a more supportive signal for risky assets. The outlook for the global economy has become more balanced.

With regards to market dynamic factors, broad equity market investor sentiment indicators have declined and those that measure investor risk appetite are close to neutral. Equity markets have shown limited strength and we see significant performance differentials. Investor positioning also differs considerably, in terms of style, region and sector. This provides opportunities in active equity management.

Fixed income remains attractive. With the repricing of Fed expectations, the current assumption for when the Fed and ECB will start cutting rates and the extent of the total number of rate cuts expected looks a lot more realistic than at the start of the year. High quality fixed income still provides an interesting yield, from a carry perspective as well as from a diversification perspective, in the event of unexpected growth setbacks. Fixed income and equities both look attractive relative to cash.

Please refer to page 5 to see how these developments figure in our asset allocation.

	UNDERWEIGHT significantly	slightly	NEUTRAL	OVERWEIGHT slightly	significantly	
1 Liquidity	↘					We have increased our underweight in cash to finance an overweight in equities.
2 Bonds				→		The outlook for high quality fixed income remains supportive. We remain overweight in investment grade (IG) credit, supporting our belief that current spreads offer a fair value risk-adjusted expected return, provided the global economy can avoid a severe downturn. We also remain underweight in high-yield bonds. In our opinion, companies with weaker balance sheets and greater dependence on external borrowing are more at risk, and their bond prices and spreads over higher quality bonds do not compensate for that risk. We should see lower yields across the curve in the quarters ahead and therefore recommend extending duration in investment grade bonds.
3 Equities				↗		At the last Investment Committee meeting, it was decided to increase the tactical allocation to equities to a medium overweight position. The macro environment has become more favorable overall for equities. We are seeing improved momentum in the global manufacturing sector, while downside risks to the US economy continue to fall. At the same time, equity investor sentiment has moderated from the peaks. We are implementing the overweight in equities via an overweight in Europe. European equities are more exposed to the global economy than other regions, which have greater earnings exposure to their “home” region. In addition, investor positioning in Europe is very light, while valuations are neutral. We believe Europe can benefit more from a continued improvement in global economic momentum.
4 Commodities / Gold			→			We maintain a positive view on gold. The yellow metal rallied strongly last year. Lower interest rates, higher economic and geopolitical uncertainties, and continued strategic buying of gold especially by emerging market central banks should be positive drivers of gold in 2024.

Changes month-on-month: same → higher ↗ lower ↘

A more upbeat macro-economic outlook

The US economy continues to surprise positively as the probability of a 2024 recession keeps declining. Can the US economy continue like that, or will a slowdown be unavoidable and can other economies recover in 2024?

—
Dr. Pieter Jansen
Chief Investment Strategist,
Vontobel SFA

US economy is holding up better
The ongoing resilience of the US economy continues to surprise analysts. Instead of slowing in the second half of 2023, GDP growth accelerated on the back of ongoing consumer spending strength with a little help from the excess savings accumulated during the Covid-19 period and sizeable fiscal stimulus. Despite the strong growth performance in the second half, the US economy is not showing signs of material cooling, with ongoing solid employment growth and strong consumer income growth.

After markets were surprised in 2023 by the absence of a US recession, the same scenario seems to be unfolding for 2024. Around the middle of 2023, economists were expecting US growth to slow in 2024 to 0.5 percent (chart 1), which has improved to 2 percent now. This is a statistical effect in part. Thanks to strong growth in the second half of 2023, real GDP was significantly above the 2023 average (1.3 percent) by the end of the year. The possibility of average growth of over 2 percent in 2024 is therefore quite realistic.

Despite the strength of US economic activity, we expect economic momentum to slow somewhat. This is not a bad development, as it would remove some inflationary pressure and allow for several rate cuts by the Fed.

Some growth drivers are expected to disappear, such as the excess savings used for consumption growth. Above-average income growth and fiscal support will disappear too. Underneath the strong labor market data, we are seeing trends that suggest a slowdown in employment growth is in the making. These include fewer job vacancies, a decline in the intention of small firms to hire new personnel and consumers indicating that it is becoming less easy to find a new job. We expect this tendency to continue.

It is surprising that after such significant monetary policy tightening that there have been no major macro incidents. On average, businesses have been able to anticipate and absorb these higher financing costs, largely thanks to stronger balance sheets and locking in low yields. However, this of course does not apply to every business. Companies with weaker balance sheets and a higher dependency on external finance are more at risk here. With regard to consumers, delinquencies have started to rise in areas like credit card payments, auto loans and mortgages. In our view, the combination of passing on higher financing costs and a normalization of the labor market will see US economic growth return to around trend this year.

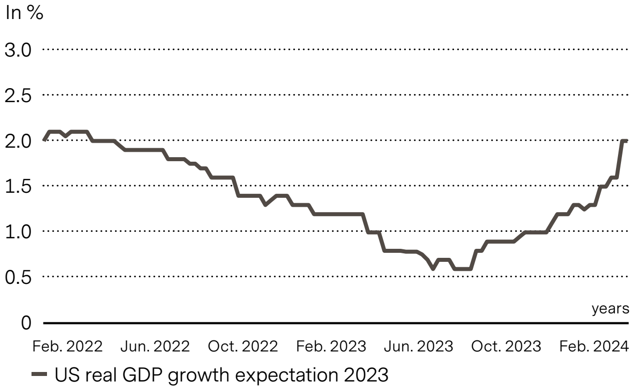
Global leading indicators are more upbeat
The global manufacturing sector was weak during 2023, which especially weighed on growth momentum in economies largely exposed to this sector. Examples of this are Germany and China. Leading indicators for the global manufacturing sector are turning. Since August 2022, the JP Morgan global PMI for the manufacturing sector has remained below 50 points, indicating that activity in the sector has been declining throughout 2023 (chart 2). A trough was reached in July (48.6 points) and after a gradual recovery the indicator returned to 50 points in January. Other indicators also confirm an improvement in the global manufacturing sector, such as the components of the US ISM manufacturing PMI, where we have seen an improvement of the differential of new orders minus inventories.

The global services sector experienced some weakness during 2023 but bottomed out at precisely 50 points. The composite PMI, a combination of both the manufacturing and services components, has accelerated to over 52 points again in February.

Positive outlook for Europe, but emerging markets are still lagging
The mix of improved global momentum in manufacturing activity and the less marked US economic slowdown is positive for the global economy on the one hand and for the European economy on the other. In fact, we are also seeing an improvement in the European PMI indicators. This is also reflected in economic surprise indices (chart 3), which track whether economic data is better or worse relative to the consensus. Analysts tend to underestimate macro-economic developments, which makes these indicators useful tools in tracking the development of economic momentum. The European economic surprise index is positive again on a standardized basis, for the first time since early May 2023. We are also seeing a positive development of economic surprises in other large industrialized economies. On balance, US and Japanese data have surprised the market positively as well.

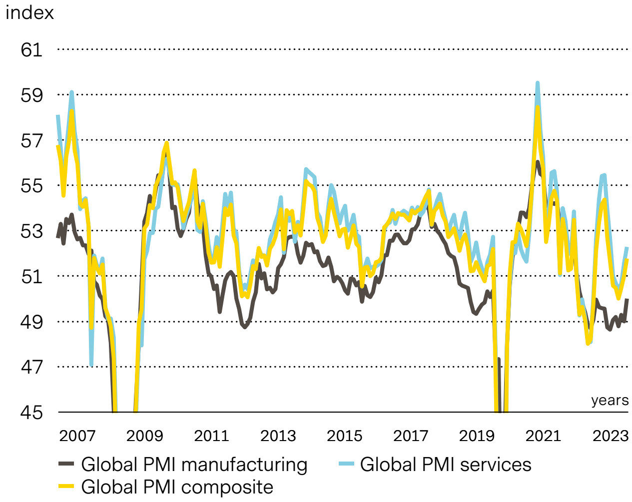
An area that is still lagging is emerging markets. Emerging markets, many of which are export oriented, would typically benefit from improved global economic momentum and continued solid US consumer spending growth. This scenario looks somewhat different this time round. Economic surprises in emerging markets may be bottoming out but they are still negative. One reason for this is that many emerging markets are focused on China, whose economy is still stuck between structural growth headwinds, deflation risks and lagging growth traction of fiscal and monetary policy. The real estate crisis remains a structural burden. Nonetheless, if global economic activity improves and continues to do so, in particular the manufacturing sector, Chinese economic growth momentum will very likely pick up as well. As yet, however, more evidence is needed to support this.

Chart 1: US real GDP growth expectations for 2023



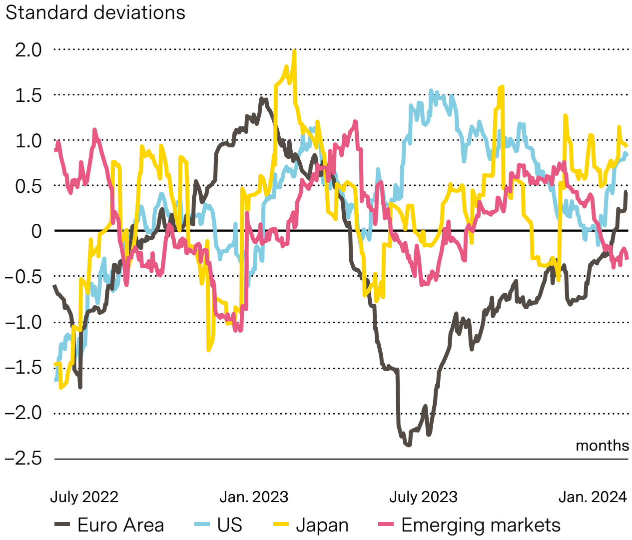
Source: Bloomberg, Vontobel SFA

Chart 2: Global PMI developments



Source: JP Morgan, Vontobel SFA

Chart 3: Economic surprise indicators (standardized)



Source: Bloomberg, Citibank, Vontobel SFA

More realistic central bank expectations

—
Matthias Ribback
Portfolio Manager,
Vontobel SFA

By the end of 2023, investors were forecasting steep rate cuts by the Fed and the ECB in 2024. Given the continued strength of the labor market on both sides of the Atlantic, these rates cuts are likely to be less pronounced and come later in the year. We do not believe this is something fixed income investors should be overly concerned about.

At the end of 2023, markets forecasted a Fed funds rate of 3.9 percent by the end of 2024 (140bp below the current rate) (chart 1). Over the past two months, these implied forecasts have risen to 4.5 percent. Also the 10-Year Treasury yield rose from 3.9 percent at the end of 2023 to 4.3 percent at the end of February. This strong upwards shift in yields comes on the back of strong US growth data, more sticky inflation and push backs by the Fed on rate cuts.

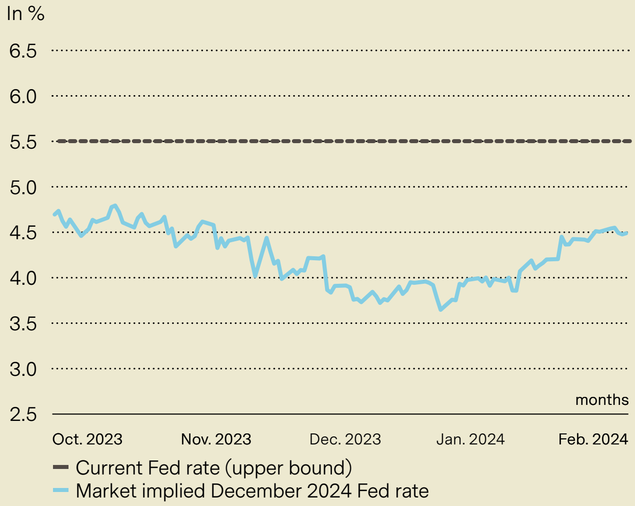
New opportunities to lock in attractive yields

Given where bond yields are now, fixed income investors are in a comfortable spot. Excessive expectations of central bank rate cuts have become more realistic. Moderate US growth and ongoing inflation expectations should all be supportive of longer duration fixed income. Additionally, high-quality bonds with longer duration can provide protection in case of an unexpected setback in growth, which would trigger more aggressive rate cutting and a flight to safety.

Short duration bonds appear at face value attractive, too. The yield on US Treasury Bills with less than 6 months to maturity hovers around 5.3 percent, however, there is a reinvestment risk here. Once central banks start to reduce interest rates, these yields will fall. Given that longer duration bonds anticipate central bank action, it may then be too late to switch to longer duration assets. This is the reason why we prefer to increase portfolio duration before the rate cutting cycle starts.

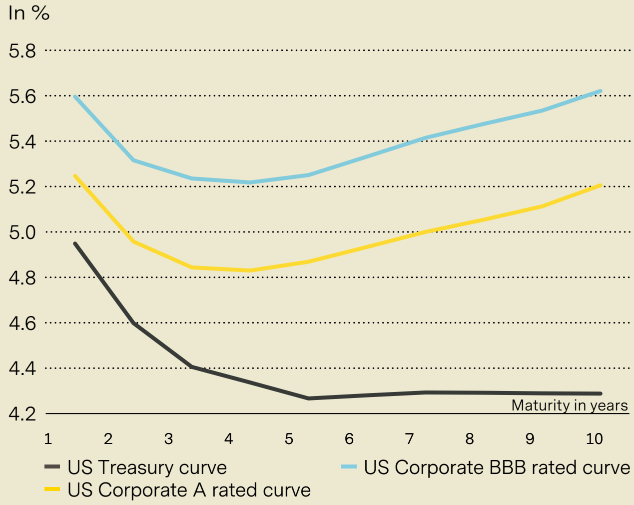
At Vontobel SFA, we still favor high quality corporate bonds over government bonds. For a slight increase in risk, investors can benefit from an interesting yield pickup. The corporate credit curves are upward sloping whereas the US Treasury curve is flat from around the five-year maturity mark (chart 2). Even though we see value in high quality bonds (A and BBB rated), we do not think lower rated bonds (BB and lower rated) compensate for the risk and we remain underweight in this segment.

Chart 1: Market implied December 2024 Fed rate development



Source: Bloomberg, Vontobel SFA

Chart 2: US Treasury and corporate bond curves



Source: Bloomberg, Vontobel SFA

A tactical move

—
Markus Bruhin
Head Managed Solutions,
Vontobel SFA

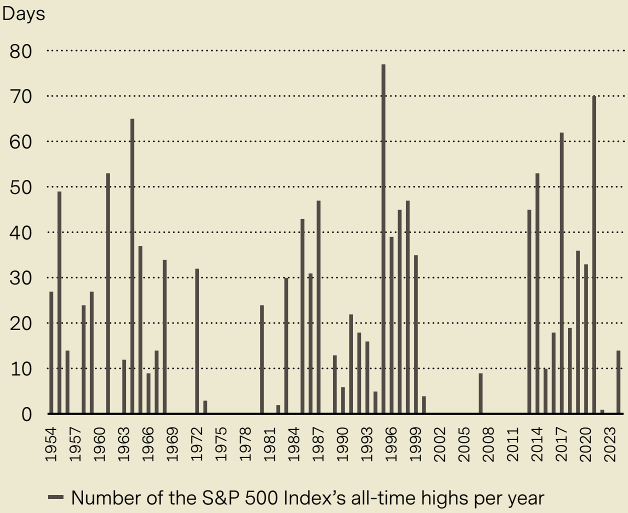
After the "almost everything rally" that characterized November and December, equity investors have become more selective since the beginning of January. The combination of solid data on economic growth and strong employment figures further fueled hopes of a soft landing. However, mixed inflation data for December and January, along with a strong economy, have led central banks to push back on impending rate cuts. This was particularly the case for the Fed, which clearly adopted a less dovish tone at its meeting in late January. Nonetheless, markets are powering ahead at the time of writing, with the MSCI ACWI Net Total Return Index up more than 4 percent year-to-date, reaching a record high and topping the December 2021 peak. Too much, too soon? We do not think so and are tactically upgrading equities to a slight overweight.

The US market remains a substantial driver of global indices, which reminds us of what transpired in 2023, when US technology-linked mega-caps led the way. Encouraging earnings in the US, particularly in the large-cap technology segment, and supportive macroeconomic data pushed the S&P 500 Index above the 5,000 mark for the first time and to its 14th all-time high since the beginning of 2024 (see chart 1). Another record has also been set already in 2024. February saw the biggest single-day market cap addition in history, first with Meta topping the leaderboard after posting fourth-quarter earnings and an almost USD 200 billion surge in market capitalization and later with Nvida with a USD 277 billion surge in market capitalization (see chart 2).

A glance at Europe shows a similar picture, with the Stoxx Europe 600 Index in positive territory too, driven by technology, communication services, consumer discretionary (particularly luxury goods) and financials. We anticipate that eurozone stocks—notoriously unloved—may be poised for a recovery as the year progresses, due to the cyclical profile and highly international composition of the indices. We believe that European EPS growth bottomed in Q4 2023 and, given low investor positioning in Europe, see room for an outperformance this year. A cyclical recovery in Chinese growth would be another support factor for eurozone stocks. At the tail end, we have emerging markets still in consolidation. Chinese stocks reflect a struggling economy, as evidenced by disappointing retail sales and a further deterioration in real estate activity.

Looking ahead
Earnings growth estimates for 2024 and 2025 do not seem too ambitious. Market dynamic factors (i.e. investor sentiment, risk appetite and positioning) also support a positive view on equities. A likely dovish shift in central banks' language should be supportive for equities as well. In that spirit, by looking at a nine- to 12-month horizon, the Vontobel SFA Investment Committee is tactically lifting equities to a medium overweight.

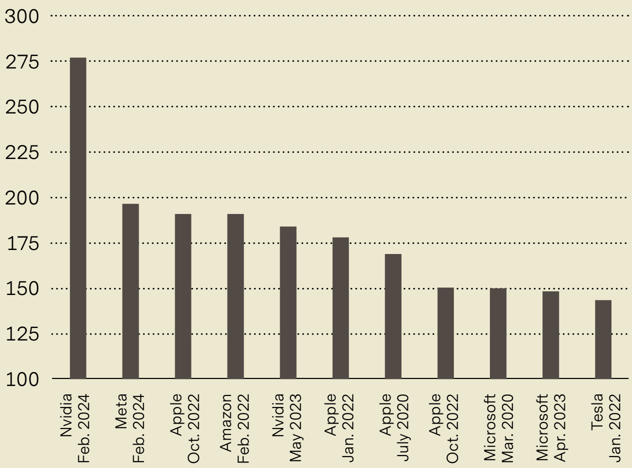
Chart 1: S&P 500 Index – Flying high



Source: LSEG, Vontobel; data as of February 16, 2024

Chart 2: Top 10 biggest single-day market capitalization gains in history

In billion USD



Source: Bloomberg, Vontobel; data as of February 16, 2024.

Oil's economic drill

—
Christoph Windlin
Deputy Head
Investment Management,
Vontobel SFA

There has been plenty of geopolitical support for oil recently – attacks on Russian oil infrastructure, failed efforts to achieve a ceasefire in Gaza and uncertainties in the Red Sea. Despite the tense situation, the WTI oil price has been trading below USD 80 since early November (chart 1).

There are mixed signals from the demand side. The International Energy Agency reduced its forecast for global oil demand; it is now expected to grow by only 1.22 million barrels per day (mbpd) in 2024 due to the weakness of the Chinese economy. This is slightly less than a previous forecast of 1.24 mbpd. The Organization of the Petroleum Exporting Countries (OPEC) is much more optimistic with its call for 2.25 mbpd. Meanwhile, travel-hungry consumers are supporting the demand for jet fuel, while solid US economic data remains strong.

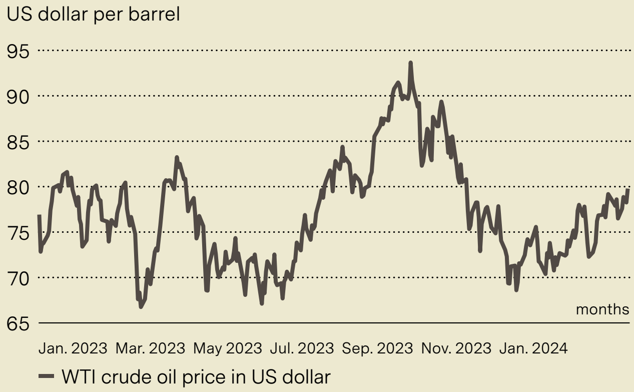
On the supply side, US oil production, which reached a record high of over 13.3 mbpd at the end of 2023, was lower than expected in January (12.6 mbpd). Extreme weather caused wells and pipelines to freeze. Along with a series of planned shutdowns, this led to a slump in refinery production to its lowest level since the end of 2022. At almost the same time, the Energy Information Administration said US oil inventories rose by 12 million barrels in the first week of February, significantly more than the expected 2.6 million barrel increase. While the increase was probably due in part to lower refinery activity, it was interpreted by some as a sign of weakening demand.

OPEC cuts

OPEC and its allies will continue with their announced production cuts until the end of the first quarter. Saudi Arabia indicated the curbs may continue beyond that. However, in view of the accumulated excess capacity and the fact that Saudi Arabia alone will have to shoulder most of the cuts, market participants appear to have doubts as to whether words will really be followed by action (see chart 2). The U-turn on Saudi Aramco's planned capacity expansion was also seen as bearish by some. The Kingdom instructed the state-owned energy company to aim for a maximum capacity of 12 mbpd by 2027, one million less than previously announced.

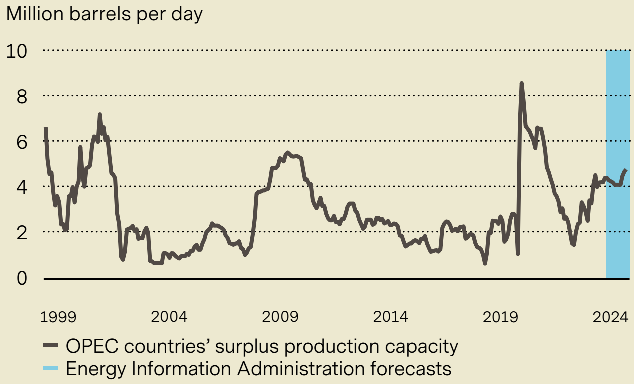
While geopolitical escalation or a significant reacceleration of the Chinese economy is not our base case, it remains a tail risk that could push prices significantly higher. In the absence of unexpected shocks, WTI oil should continue to trade in a range of USD 70 to USD 85.

Chart 1: WTI crude oil price in US dollar



Source: Bloomberg, Vontobel SFA

Chart 2: Surplus capacity will become a topic in 2024



Source: LSEG, Vontobel; data as of February 16, 2024

A Swiss surprise

—
Dr. Pieter Jansen
Chief Investment Strategist,
Vontobel SFA

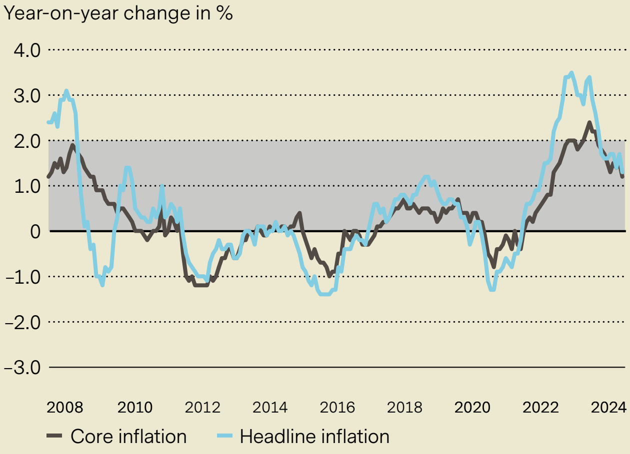
The Swiss franc depreciated slightly against the euro and weakened more significantly against the US dollar in January, which is when outgoing Swiss National Bank (SNB) President Thomas Jordan said the central bank is increasingly worried about the franc's strength and its negative impact on Swiss businesses.

A strong currency is no help amid worries about an economic downturn and deflationary conditions. Swiss inflation data took an unexpected turn in January, possibly paving the way for the SNB to consider rate reductions sooner than anticipated. Headline consumer prices increased by 1.2 percent from a year earlier in February. The core inflation rate, which excludes the impact of volatile items such as energy and food, decelerated to 1.1 percent (see chart 1). The January decline was particularly surprising, as some prices within the Swiss economy are controlled. Moreover, electricity costs and value-added tax increased at the start of the year. Economists were initially eyeing September for the SNB to commence rate cuts, but the lower-than-expected inflation has prompted some to bring that timeline forward. Also, the SNB will see a change of leadership in September, when Jordan steps down. This could perhaps make a change in monetary policy direction less likely. The market-implied probability for a 25-basis point cut in March has doubled to more than 60 percent from around 30 percent. The SNB, unique among its global counterparts, convenes quarterly, making its schedule less flexible.

US dollar's short-term strength but medium-term challenges

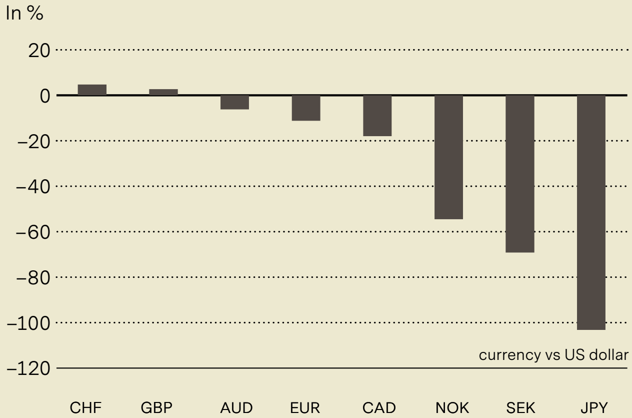
The recent strength of the US dollar can be explained by better US growth data, disappointing inflation data (higher than expected) and the repricing of Fed expectations versus other central banks. From a medium-term perspective, the US dollar is overvalued versus most currencies (chart 2). The real effective exchange rate of the US dollar has increased by close to 30 percent over the past 10 years versus the US trading partners. In other words, the dollar rose significantly beyond what can be justified based on inflation differentials. Over the same period, the Swiss Franc rose by 5.5 percent and the euro fell by 2.9 percent in real effective terms. When we look at specific currency pairs, we see that particularly the Norwegian Krona, the Swedish Krona and the Japanese yen are undervalued versus the US dollar.

Chart 1: Swiss inflation shows surprise slowdown



Source: Bloomberg, Vontobel

Chart 2: Over- (+) and undervaluation (–) versus US dollar



Source: Bloomberg, Vontobel SFA

Economy and financial markets 2022 – 2025

The following list shows the actual values, exchange rates and prices from 2022 to 2023 and consensus forecasts for 2024 and 2025 for gross domestic product (GDP), inflation / inflationary expectations, key central bank interest rates, ten-year government bonds, exchange rates, and commodities.

GDP (IN %)	2022	2023	CURRENT[1]	2024 CONSENSUS	2025 CONSENSUS
Global (G20)	2.9	2.7	2.9	2.3	2.6
Eurozone	3.4	0.5	0.1	0.5	1.4
USA	1.9	2.5	3.1	1.6	1.7
Japan	1.0	2.0	1.0	0.8	1.0
UK	4.5	0.3	–0.2	0.4	1.2
Switzerland	2.7	0.8	0.4	1.2	1.5
Australia	3.8	1.9	2.1	1.4	2.2
China	3.0	5.2	5.2	4.6	4.4

INFLATION	2022	2023	CURRENT[1]	2024 CONSENSUS	2025 CONSENSUS
Global (G20)	7.5	4.4	3.6	5.3	3.3
Eurozone	8.4	5.5	2.8	2.3	2.1
USA	8.0	4.1	3.1	2.7	2.3
Japan	2.5	3.2	2.6	2.2	1.7
UK	9.1	7.3	4.0	2.6	2.1
Switzerland	2.8	2.2	1.3	1.5	1.4
Australia	6.6	5.7	4.1	3.4	2.8
China	2.0	0.2	–0.8	1.0	1.7

KEY INTEREST RATES (IN %)	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR	2.50	4.50	4.50	4.25	3.25
USD	4.50	5.50	5.50	5.15	3.90
JPY	–0.10	–0.10	–0.10	–0.02	0.05
GBP	3.50	5.25	5.25	5.05	3.85
CHF	1.00	1.75	1.75	1.60	1.16
AUD	3.10	4.35	4.35	4.35	3.70
CNY	3.65	3.45	4.35	4.25	–

GOVERNMENT BOND YIELDS, 10 YEARS (IN %)	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR (Germany)	2.6	2.0	2.38	2.19	2.15
USD	3.9	3.9	4.27	3.87	3.69
JPY	0.4	0.6	0.74	0.85	0.95
GBP	3.7	3.5	4.09	3.79	3.55
CHF	1.6	0.7	0.91	0.85	0.96
AUD	4.1	4.0	4.19	4.27	3.87

FOREIGN EXCHANGE RATES	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
CHF per EUR	0.99	0.93	0.95	0.96	–
CHF per USD	0.94	0.84	0.88	0.87	–
CHF per 100 JPY	0.72	0.60	0.59	0.61	–
CHF per GBP	1.12	1.07	1.11	1.10	–
USD per EUR	1.06	1.10	1.08	1.10	–
JPY per USD	130.00	141.00	150.00	142.00	–
USD per AUD	0.67	0.68	0.65	0.68	–
GBP per EUR	0.88	0.87	0.85	0.86	–
CNY per USD	6.91	7.10	7.19	7.13	–

COMMODITIES	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
Brent crude oil, USD per barrel	86	77	83	83	83
Gold, USD per troy ounce	1,824	2,063	2,005	2,050	2,115
Copper, USD per metric ton	8,372	8,559	8,314	8,500	9,091

[1] Latest available quarter
[2] Latest available month, G20 data only quarterly
Source: Vontobel, respective statistical offices and central banks; as of February 16, 2024

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