Investment Focus

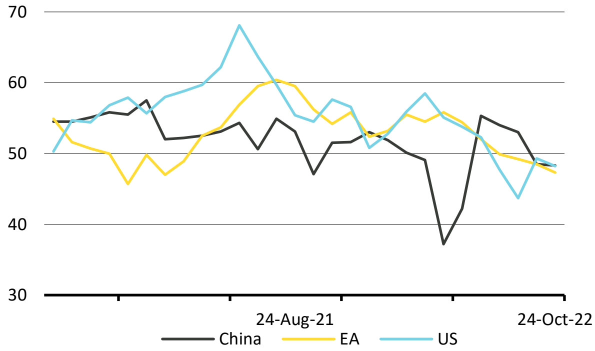
Bumpy road ahead

Investment decisions mainly driven by peak inflation and Fed pivot expectations

Persistent elevated inflation, heightened uncertainty about energy supply and energy costs, together with the unknown impact of the Ukraine war on future economic and geopolitical development, are weighing heavily on the global economy. Growth of world trade slowed from an average rate of 4.5% in the first quarter of 2022 to slightly above 3% in the second quarter. This compares to 2021, where world trade expanded by approximately 7% in the first quarter and even accelerated to above 20% in the second quarter.

According to the latest survey results of the Purchasing Managers' Indices (PMIs) the outlook for the main economic regions of the world has significantly lost momentum. The indices fell over the summer months below the important threshold of 50, indicating that most corporate leaders now expect economies to contract over the coming quarters. Global supply chain disruptions, however, continue to recover, energy prices are stabilizing, and monetary policy makers have taken credible measures to bring inflation back to the long-term policy objectives.

Purchasing manager indices (PMI Composite) – In decelerating territory



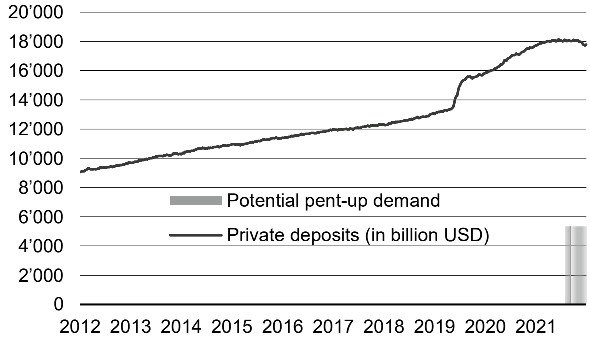
Source: Bloomberg Finance L.P., Vontobel SFA, as of October 2022

The loss of purchasing power due to the fastest increase in, and the highest level of, inflation since the late 1970s and early 1980s, the reversal of the monetary policy stance from easy money during the COVID-19 pandemic to higher central bank rates, tighter funding costs for companies and private households and reduction of central banks' balance sheets are expected to slow down the global economy. This will lead to rising unemployment, stalling personal consumption growth and slower fixed capital formation, resulting in much slower domestic demand growth. Whether this leads to a severe downturn of the global economy depends on the extent of monetary policy tightening, including the level of the terminal central banks rates in the major global economic regions that is needed to create the new balance of economic growth, unemployment, and stable inflation.

The ongoing tight US labor market in terms of quit rates, job openings and the lowest unemployment rate (approximately 3.5%) in decades is fueling concerns that the Fed still has some way to go before attaining its goal of cracking current inflation. Similarly, central bank representatives will not admit that the path through higher rates, the impact on domestic demand and inflation is in all likelihood, a medium-term process. Causal evidence from the late 1970s and the early 1980s in the US indicates that this process may last two to three years in order to succeed and the likelihood of overdoing it is rather high. Central banks in the advanced economies emphasize this risk and are fueling expectations that they will soon decelerate the pace at which they are hiking rates, especially in the US and the UK where a further slowdown of economic momentum is projected.

Real private household consumption accounts for approximately 70% of real GDP in the US. This component is therefore the main contributor to real US GDP growth. In the third quarter, real personal consumer spending slowed from 0.5% in the second quarter to 0.35% despite high employment and strong disposable income. The main reasons for the weak rise of real personal consumer spending are rising funding costs due to tighter financial conditions and the loss of real purchasing power as a result of elevated inflation. Higher nominal costs for gas and food have been funded by a significant reduction in personal savings. Personal savings have declined by 4.5 percentage points to around 3%. During the pandemic, savings rates reached more than 30% raising concerns of pent-up demand created by these forced savings. Savings, however, are not the correct variable to evaluate how much pent-up demand is still available. They (savings rates) are the result of income generation, and it is accumulated savings held in bank deposits that are a proxy for potential pent-up demand in the economy. Private deposits have increased by around 10 percentage points since the beginning of 2020, as forced savings started in response to the lockdown measures that were enforced to contain the virus. This represents excess deposits of approximately USD 5,250 billion or around 20% of the US nominal GDP.

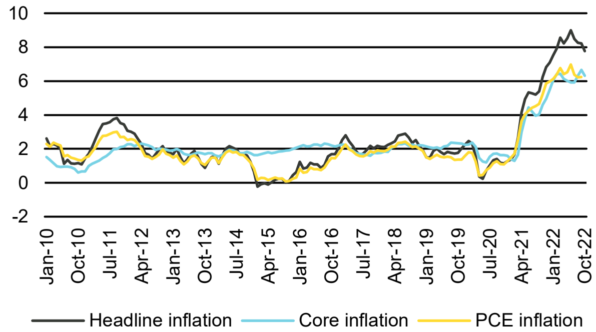
Total private deposits at all US commercial banks (in billion USD)



Source: Federal Reserve Bank St. Louis, Vontobel SFA.

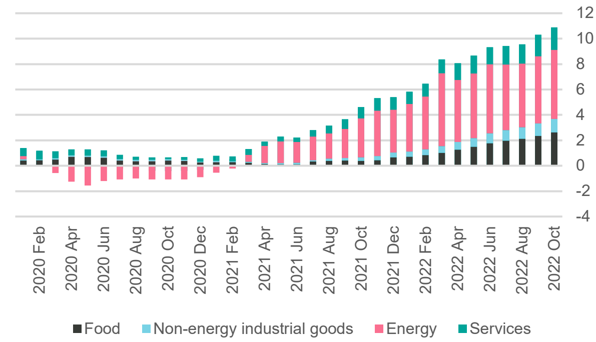
US headline inflation appears to have peaked in early summer when inflation reached more than 9%. Since then, headline inflation has declined by around 1.4 percentage points and core inflation, excluding food and energy inflation, has stabilized at slightly above 6%. As core inflation is dominated by housing services such as housing rents and usually lags overall inflation, peak core inflation lags headline inflation. Base effects for housing rents and core inflation should also kick-in soon and lead to a deceleration of core inflation. This recent inflationary pressure and easing inflation trajectory for the US economy have already triggered debates about the future direction of US central bank rates. The Fed should potentially have leeway to lower the scope and speed at which the rates are adjusted to the terminal rate. Even the expected terminal rate has come under scrutiny.

US inflation trends (in % a year ago)



Source: Federal Reserve Bank St. Louis, Vontobel SFA

Euro area inflation and its components (in %-points)



Source: European Central Bank, Vontobel SFA

According to the European Central Bank's (ECB) November 2022 economic outlook, economic activity in the euro area was stable in the first half of 2022, with GDP growth averaging at 0.7%. This was mainly due to domestic demand and net trade. On the production side, value added from the service sector was the primarily contributor to economic growth. economic activity, however, is expected to slow down significantly with most leading indicators such as the PMI, ZEW and the IFO indices decelerating. For example, the Composite PMI index dropped below 50 threshold into contractive territory and down to 47.3 by October. Interconnected factors are mainly responsible for the decline in economic momentum in EA. First, the persistent rise in inflation has taken its toll on domestic spending and has increased production costs. Expected natural gas supply disruption and even potential rationing have led to a significant decline in corporate capital spending growth, which had already dropped to 0.8% after expanding previously. Second, following the full reopening of the service sector at the end of last year, the main driver of economic rebound in the first half of 2022 will lose steam in the months ahead. Third, the slowdown of global economic momentum in tandem with tighter monetary policy worldwide and a deterioration of the EU Real Effective Exchange Rate (REER) implies further headwinds for the EA economy. Fourth, figures on uncertainty and confidence measures released by the European Commission are falling sharply and are projected to dampen further domestic demand.

This downward trend in economic activity in EA can only be partially offset by the stock of excess savings accumulated since the end of 2019. According to the ECB, this currently amounts to approximately EUR 900 billion. Personal deposits in excess of the end of 2019, however, only amounted to around EUR 360 billion.

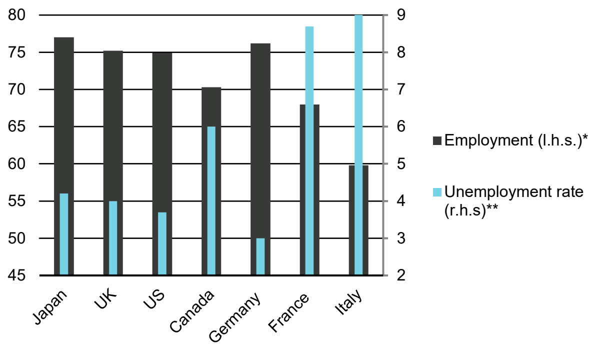
Inflation continued to rise over 10% in October. The energy component accounted for around 50% while the food component added another quarter to the overall inflation rate. This implies that these volatile elements account for three quarters of the current inflation rate.

Risks to inflation are biased to the upside, depending on how retail energy prices such as gas develop. In the medium-term, inflation may increase further if energy and food commodity prices continue to rise at a faster pace than before and are passed on to consumer prices. If most price components of the EA consumer price index start to stabilize, albeit at a high level, the statistical year-on-year base effects (peak inflation in EA) will occur over the coming six months. This means that inflation in EA will start to decline. Besides food and energy prices stabilizing, the speed of this disinflation process and inflation approaching the policy objective of 2% depends on whether employees demand compensation for the loss of real purchasing power. If this exceeds productivity growth, it could contribute to a further temporary acceleration of inflation. How likely is such an excessive wage demand and the risk of a wage-price-spiral? The latest ECB Consumer Expectations Survey (CES) shows that inflation expectations in EA for the next 12 months remained stable at around 5% and at around 2.5% for the coming three years. Against this backdrop, higher wage growth is expected to offset some of the loss of real purchasing power. It is rather unlikely, however, that wage growth will trigger a wage-price-spiral and a further acceleration of inflation in EA.

The Chinese economy was a drag on global economic activity this year. The slump of more than 50% in housing starts and decline of over 30% in housing sales in 2022 caused significant turmoil in the Chinese real estate sector. This downturn in the real estate market presents serious financing challenges for local governments and other companies operating in this market, including their debt servicing ability and spending power in 2023. Negative real estate wealth effect will also impact on household consumption. Weaker activity on the real estate market is expected to weaken demand for and investment in the upstream heavy industrial sectors. Real estate related bad debt is set to rise and will probably take the banks years to resolve. The reintroduction of strict zero COVID-19 policy measures to contain the virus throughout 2022 caused GDP growth to decelerate significantly this year. Important regions have been locked down and personal consumption and corporate investment dampened. Going forward, we expect the Chinese economy to recover based on assumptions that the downturn on the real estate market will no longer impact GDP growth. The government has provided a clear roadmap for an end to the lockdowns, confirming reopening rumors in the market in recent weeks. These include officials looking to form committees to put together a reopening plan for 2023 and the former chief epidemiologist's comments about China making "substantial changes" to its zero COVID-19 policy. Separate reports state that authorities are planning to ease travel and quarantine rules. Assuming that lockdown measures are lifted next year, this should support an acceleration of personal consumer spending and capital spending. Given the weak outlook for global economic activity, Chinese manufacturing and exports are expected to soften slightly. Overall, economic development in China for 2023 is one of the few silver linings for the global economy.

Labor tightness is currently an international phenomenon
Labor market tightness is not an isolated phenomenon of the US economy. A very recent study of the Organization for Economic Co-operation and Development (OECD) reveals that this situation is also evident in other major advanced economies. Employment in most advanced economies is back to pre-crisis levels and unemployment rates have fallen below these levels too.

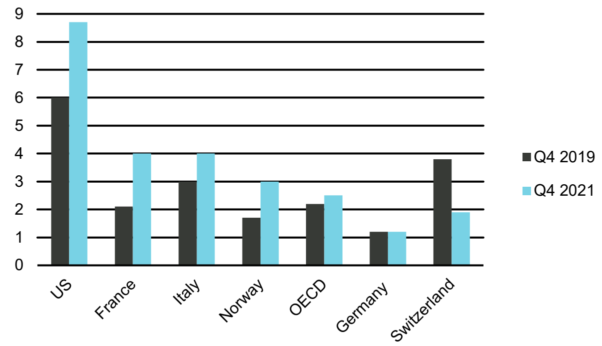
Employment and unemployment rates for selective economies



Source: OECD, The post-COVID-19 rise in labor shortages, October 2022
*in percent of total labor force
**in percent of total labor force

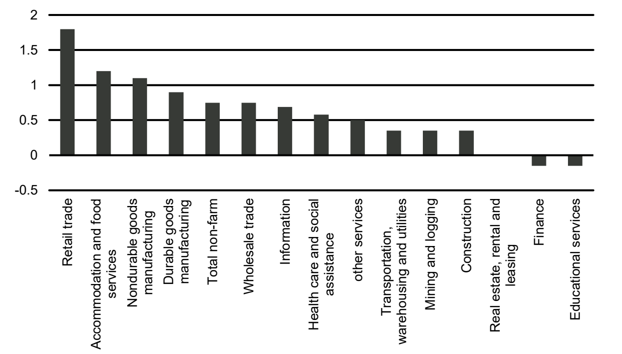
Other indicators such as the vacancy-to-unemployment ratio, the vacancy and the quit rate also point to clear labor shortages in most advanced OECD economies since the onset of the COVID-19 pandemic. For instance, the US labor market reports more than 1.6 unfilled jobs per unemployed person. This is approximately 0.5 percentage point higher than the pre-crisis figures. While the situation is less pronounced in EA than in the US, European labor market departments also state that this measure of labor market tightness has doubled from 0.4 to 0.8 unfilled jobs per unemployed person in the aftermath of the COVID-19 crisis.

Quit rates Q4 2019 versus Q4 2021



Source: OECD, The post-COVID-19 rise in labor shortages, October 2022

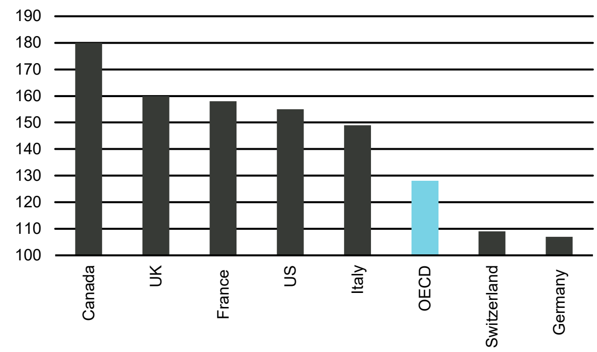
Percentage changes in quit rates across industries in the US – Dec. 2019 to Dec. 2021



Source: OECD, The post-COVID-19 rise in labour shortages, October 2022

The vacancy rates for selected OECD economies also show that labor demand is strong. Compared to the vacancy rates in the fourth quarter of 2019, job openings in the English-speaking economies have increased by between 50 percentage points in the US to over 80 percentage points in Canada. European economies are also complaining about labor shortages. In France and Italy, current job openings are 50 percentage points higher compared to the fourth quarter of 2019. It stands at seven percentage points in Germany, as this metric does not differentiate between skilled and unskilled workers. According to the German Ministry of Labor and Social Affairs, German employers are in need of skilled workers, while many OCED economies are looking for lower and low-skilled employees, mainly in the service sector of leisure, restaurants and shopping malls.

Vacancy rates for selected OECD economies* (in % of unfilled jobs to total jobs)



Source: OECD, The post-COVID-19 rise in labor shortages, October 2022
*rebased to 100 = Q4 2019

Rising vacancy rates have gone hand in hand with rising quit rates. Quit rates show the numbers of workers who voluntary quit their jobs relative to total employment. This phenomenon is now known as the “Big Quit” or “Great Resignation” and describes how record numbers of low-paid workers who were very disappointed with their treatment by former employers during the lockdown periods have quit their jobs. From an economic point of view, rising quit rates may reflect several factors including cyclical and structural factors.

On the cyclical side, rising job mobility is positively correlated with tighter labor market conditions, as tighter labor markets raise the bargaining power of workers. This is especially so in the US where the trade union membership is traditionally low. Intensified bargaining power may lead to a stronger wage drift. Tighter labor markets also provide outside options and incentives to look for new employment opportunities with better pecuniary and non-pecuniary conditions.

On the structural side, a recent analysis conducted by the International Monetary Fund (IMF) shows that the COVID-19 pandemic may have triggered a change in work preferences, especially for employees who had been at the forefront during the pandemic. According to the IMF, workers no longer accept poor employment conditions, such as low-pay, shift hours, health risks, stressful tasks and poor social benefits. The data provided by the IMF provide some evidence for this hypothesis: (1) retail trade, food and hospitality, as well as manufacturing show the greatest increase in quit rates, (2) there is a strong negative cross-industry correlation between quit rates and pre-pandemic earnings, and (3) there is a strong positive cross-industry correlation between quit and vacancy rates.

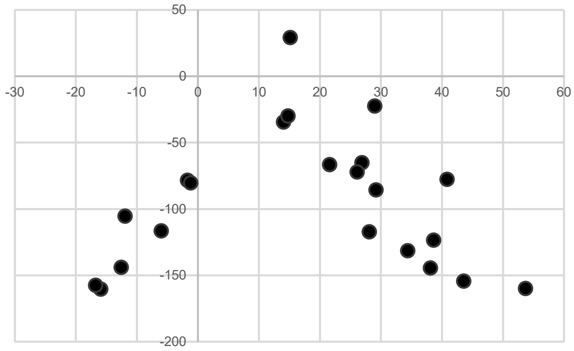
Preliminary evidence drawn from country-specific studies reported by the OECD in 2022 shows rising job mobility within industries along with stable cross-industry job mobility. This is especially relevant for low-skilled workers who cannot rapidly requalify to switch industry, but who can nevertheless climb the job ladder by changing employer within the same industry. This overall picture and argument would be consistent with a new Pew Research Center survey: (1) low pay, a lack of opportunities for advancement and feeling disrespected at work are the top reasons why Americans quit their jobs last year, and (2) those who quit and are now employed elsewhere are more likely than not to say their current job has better pay, more opportunities for advancement, better work-life balance and more flexibility.

Asset allocation: maintaining equity investments at the strategic allocation weight

Why is this year different?

For decades, the negative correlation between equities and bonds has been paramount for multi-assets investors and the mantra of diversification. If equity returns go up, bond returns are expected to fall and vice versa. This year, the correlation between bonds and equities measured until the end of September has switched from negative to positive. This is a rare event that has happened only three times in the last nine decades. This correlation reversal led to equity returns of more than minus 20% and to bond returns of slightly less than minus 20% in 2022. Why did the negative correlation mantra between bonds and equities not continue this year? We identify three components that influence the direction of equity and bonds returns: (1) uncertainty about the level of real interest rates, (2) uncertainty about future inflation and (3) the future stance of monetary policy relative to the respective business cycle.

Bond equity correlations 2021 and 2022* (Bond performance)

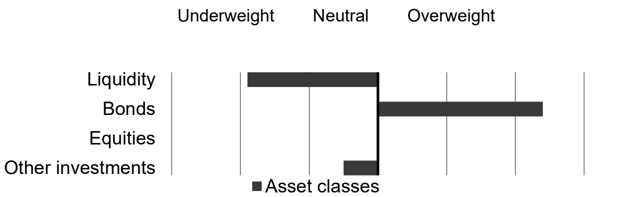


Source: Bloomberg Finance L.P., Vontobel SFA
*These calculations are based on the 12-month percentage changes of the S&P 500 and the 12-month percentage change of the 10-year US government bond yield. The vertical axis displays the equity performance, the horizontal axis displays the bond performance.

Without going into too much detail, we can draw the following conclusions about the impact of the three components mentioned above and their interaction on equity-bond correlations. (1) Higher rates volatility due to uncertainty about the future economic trajectory should lead to a lower risk appetite. *Ceterus paribus*, higher uncertainty associated with greater fluctuation of real rates is negative for both equity and bond investors and causes positive equity-bond correlation. This scenario is currently observed. (2) Rising inflation and the uncertainty about future inflation is negative for bond prices, as investors demand a higher inflation premium for holding nominal debt. For equities, the impact of rising inflation is less straightforward. Higher expected prices should lead to higher expected nominal earnings. If, however, higher expected nominal earnings go hand in hand with higher discounting rates, because future nominal earnings are worth less in today’s money, the net impact of higher future earnings and higher discount rates determine how equities returns look. As a rule of thumb, should inflation persistently exceed 3%, the discount rate effect dominates the nominal earnings impact and equities prices should fall. Again, this is what was observed during 2022. (3) The question now is how monetary policy can influence the equity-bond correlation. Simple textbook economics teaches us that rates should be raised (corresponds to a counter-cyclical monetary policy) if economic growth is strong or projected to strengthen. This leads to a positive correlation between economic growth and rates and contributes to a negative equity-bond correlation. But if investors perceive pro-cyclical monetary policy – falling economic momentum and higher rates – the equity-bond correlation becomes positive. This is exactly what has happened during 2022, when investors started complaining that central banks in the advanced economies had fallen “behind the curve”, especially in the US. With headline and core inflation peaking in 2022, less tighter than expected monetary policy needed to move inflation to the longer-term objective and a noticeable deceleration of economic activity in the advanced economies, this current trend of a positive correlation between bonds and equities may continue well into the next year, in the US in particular. Lower Fed Funds rate, lower funding costs and therefore lower risk-free rates to discount future cash flow are positive for equities and corporate credit, but also for government bonds. This is because lower inflation and lower-than-expected central bank rates can reduce the embedded risk and inflation premia.

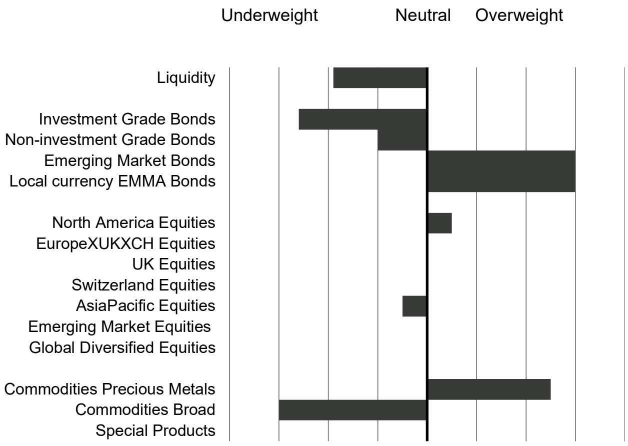
Against the economic and policy backdrop, our tactical asset allocation is driven by balancing the risks and the respective opportunities offered by the respective asset classes. With the sharp re-rating of equities since the beginning of this year, equity market valuations have become attractive again. The cyclically adjusted price-to-earnings ratio for US equities, for instance, has declined by ten index points to around 26, close to the long-term average. Emerging Asia equity valuations have dropped below their long-term averages and equities in Europe, including EA, the UK and Switzerland also offer attractive valuations. At the same time, rising inflation and tighter monetary policy have led to higher government bond yields and wider credit spreads, which has increased the relative attractiveness of fixed-income investment compared to equities.

Asset class preferences



Source: Vontobel SFA, as of October 2022, based on PM Global Balanced USD

Sub-asset class preferences

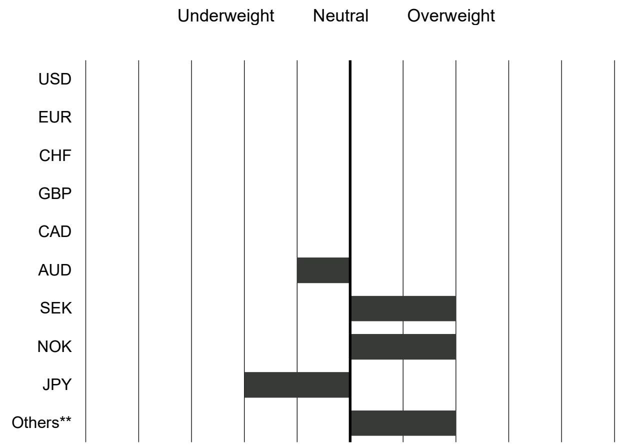


Source: Vontobel SFA, as of October 2022, based on PM Global Balanced USD. Investment grade bonds include government, government related and investment grade corporate bonds. As we are overweight investment grade corporate bonds, we are strongly underweight government and government related bonds which constitutes the overall underweight allocation to investment grade bonds.

We believe that economic growth should decelerate in the months ahead, especially in the advanced economies. Lower economic activity should have a negative impact on earnings growth; the deeper the economic downturn, the larger the decline in earnings growth. It remains to be seen how severe the economic downturn might be and to what extent central banks raise rates to curb inflation. We have therefore decided to maintain an equity allocation close to the strategic weight. Balancing attractive valuations versus cyclical risks, we believe it is too early to add additional risks to our portfolios. Nonetheless, it seems appropriate to maintain a neutral equity exposure in order to participate in any further equity market rebound, if the economy and inflation improve earlier than expected.

Within the fixed income space, we continue to favor reference currency investment grade corporate debt. Investment grade credit spreads have widened by around 0.6 percentage points for US and EUR denominated corporate bonds. We consider these spreads attractive, as they should offset the default risk that is projected to stay relatively low. We are also adding selective quasi-government bonds offering a return of more than 4% for five-year USD denominated bonds and of around 2.2% for EUR denominated debt. If the economic downturn is sharper than we expected, these bonds should provide some cushion for the expected total return on our portfolios. From a spread perspective, emerging market debt, denominated in hard and local currencies, offer attractive expected returns. We do not expect the USD to appreciate significantly further, especially if a greater US economic downturn forces the US Federal Reserve to stop raising rates or potentially lower rates again to support the US economy. In this scenario, investors are more likely to reverse capital flows into higher yielding assets.

Currency preferences* (six months)



Source: Vontobel SFA, November 2022
*Shows the preferences of international currencies vis-a-vis the USD
**Refers mainly to local emerging market currencies

In our global and international mandates, we continue to hold an overweight allocation to the Norwegian krone (NOK). The Norwegian central bank, the Norges Bank, will continue to raise rates above market expectations. This offers scope for the NOK to appreciate further against our reference currencies. The same reasoning applies for the Swedish krona, which we use in our international mandates to diversify our currency exposure. We are keeping an overweight allocation to gold. In the past, gold as an asset has proven to be a solid portfolio diversifier, should uncertainty and volatility start to intensify again.

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