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Vontobel

US Investors' Outlook

Falling into place

September 2024

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Falling into place

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

As summer fades and this publication returns from its break, our team has been raking through the changing leaves that may have shifted market dynamics.

Early last month, investors faced a series of market-moving events: weaker US employment data; a surprise rate hike by the Bank of Japan; underwhelming earnings from some of the technology sector's heavyweights that had long buoyed the stock market; and rising tensions in the Middle East. These developments reignited fears of a recession, triggering a sell-off. It served as a sobering reminder that some investors had perhaps been too optimistic.

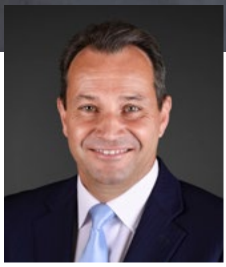
Given that August is typically characterized by light trading volumes, limited news flow and with many investors on vacation, the wild swings were quite possibly amplified by these illiquid conditions; indeed, after this setback, markets rebounded quickly.

We have maintained a steady focus in our asset allocation with a constructive view on equities. We also have overweights in higher rated investment grade bonds with longer duration and gold. During the August sell-off, these assets provided some protection against the struggling equity market. We maintain our view for a soft-landing for the US economy but remain vigilant and aware of the sudden squalls that could create potential pitfalls in geopolitics, macroeconomic shifts or raise concerns about government deficits.

On a brighter note, US inflation eased for a fourth consecutive month in July, bolstering expectations for the US Federal Reserve (Fed) to come through with a long-awaited rate cut this month. Chair Jerome Powell's important speech[1] at the Fed's annual meeting in Jackson Hole, Wyoming, signaled that the long-awaited rate cut is indeed around the corner, with Powell saying, "The time has come for policy to adjust", as inflation is on a trajectory towards its two percent goal and amid an "unmistakable" slowdown in the labor market. Powell did not provide details about the magnitude of the rate cut or what the Fed's roadmap looks like through the end of the year, but he made it clear that the Fed does not "seek or welcome further cooling in labor market conditions". That might indicate a stronger response from policymakers to any signs of weakness in growth.

As the leaves turn and the winds shift, we remain rooted amid jittery markets fueled by recession fears and anticipated policy changes. We aim to help you harvest the opportunities this season brings.

[1] Source: Fed Chair Jerome Powell's speech, August 23, 2024. www.federalreserve.gov/newsevents/speech/powell20240823a.htm



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Summer market jitters

There was a 12 percent rally in the MSCI World which started after the April correction and lasted until mid-July when investor sentiment turned during the summer and especially in August when that sentiment dived.

A combination of macro and company news caused the decline in equities, likely exacerbated by low summer volumes. Key triggers were most notably a few disappointing tech company earnings reports, weaker macro news, worries about Bank of Japan rate hikes and geopolitical uncertainty. That said, the market rebounded quickly and managed to lock in gains in both July and August.

Where does that leave us going forward? On the one hand, the progress on returning inflation further towards target has put most central banks on the path of easing some monetary policy tightening. The Fed will likely follow this month with a rate cut. On the other hand, there are some signs of a loss of macro momentum. Even though the data remains in line with our soft-landing view, we continue to observe the data flow closely.

In our view, staying invested with a special focus on diversification remains key as we go through macroeconomic adjustments against a background of relatively high geopolitical uncertainty. The overweights in high-quality duration bonds and gold worked well during the summer.

We have refrained from making further changes to our portfolio. Further details on our asset allocation can be found on page 5, along with an in-depth analysis of cyclical risks on page 6.

	UNDERWEIGHT significantly	UNDERWEIGHT slightly	NEUTRAL	OVERWEIGHT slightly	OVERWEIGHT significantly	
1 Liquidity	→					We are keeping a significant underweight in cash, as we see scope for bonds and equities to outperform versus cash.
2 Bonds				→		The outlook for high-quality fixed income remains supportive despite declining yields over the past few months. We remain overweight in investment grade (IG) credit. We continue to have a preference for high quality and remain underweight in high-yield bonds. In our opinion, companies with weaker balance sheets and a 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 still see lower two-year and 10-year rates in the quarters ahead and therefore recommend extending duration in investment grade bonds.
3 Equities				→		We are keeping equities at a medium overweight. The fundamental outlook remains constructive overall for equities. Despite some stalling in global manufacturing momentum, the overall drivers of corporate earnings growth remain solid. Regionally, we prefer the euro area and Switzerland, while the UK remains an underweight in our tactical allocation.
4 Commodities / Gold			→			We maintain a positive view on gold. Even though we are neutral commodities overall, we are overweight gold versus the other commodities within the asset class. The yellow metal rallied strongly last year and has continued to do so this year. Lower interest rates, greater geopolitical uncertainties and continued strategic buying of gold, especially by emerging market central banks, remain positive drivers.

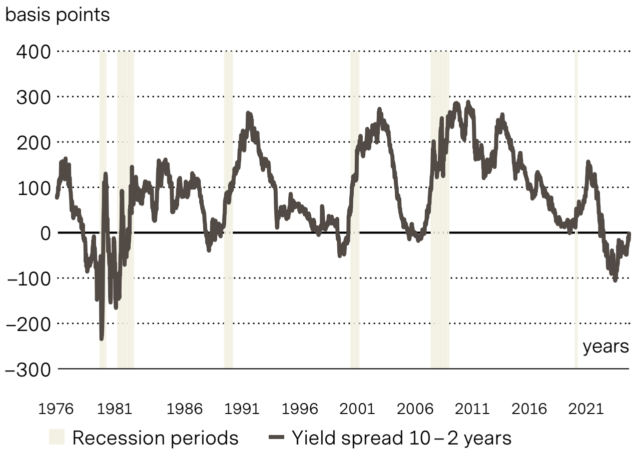
Changes month-on-month: same → higher ↗ lower ↘

Macroeconomic turbulence

The market started to get worried in August about the macroeconomic developments in the US. Central to these concerns were the labor market developments with a clear shortfall in employment growth according to the nonfarm payroll survey for July (114,000 new jobs versus a market expectation of 175,000) and a continued rise in the unemployment rate (from 4.1 to 4.3 percent), against a market consensus for it to have remain unchanged.

—
Dr. Pieter Jansen
Chief Investment Strategist,
Vontobel SFA

Chart 1: Yield curve slope and recessions



Source: Bloomberg, Vontobel SFA

One of the focal points was the Sahm rule, named after the Federal Reserve economist Claudia Sahm. The rule focuses on the moving average of an unemployment increase by tracking the average of the past three months versus the low in the previous 12 months. The signal is given when that gap increases by more than 0.5 percentage points. Historically it has often coincided with recessions. It is not a leading indicator, as it tends to lag historically. This is understandable, as hiring levels typically fall when a recession starts and redundancies pick up. It takes several months of weak or negative employment data before the unemployment rate starts to rise. Hence, even though the labor market itself is not a leading indicator, there are other labor market indicators, such as hiring intentions, jobless claims and monthly employment data that will typically give an earlier signal than the unemployment rate. Historically, jobless claims and employment growth were well below trend in the six months before the Sahm rule gives its signal. This time round, both employment growth (as measured by the non-farm payrolls survey) and the initial jobless claims were quite strong. The unemployment rate is also affected by supply-side factors (number of people joining / leaving the workforce).

In our view, it is best to look at a broad set of leading economic and financial indicators to determine the direction of the economy and not to single out rules of thumb. After all, we have already seen that this cycle before with the focus on the yield curve signal. The yield-curve slope, measured as the difference between the 10-year yield and 2-year yield on government bonds, is one of those early recession indicators (see chart 1). Theoretically it makes sense: inflation rises and central banks increase interest rates to battle inflation. This pushes short term interest rates up while 10-year yield investors look beyond the cyclical development and factor in a lower average short-term interest rate in the long-run with inflation at a lower level. This pushes short interest rates above longer rates and as higher finance costs impact the economy, it falls into recession. Historically, negative

10–2 year yield spreads were only seen somewhat before a recession. The "term premium", which is the premium investors demand for holding longer-term bonds, is customarily positive. In a neutral environment the yield curve is therefore positive. This has changed over the past decade, with the term premium continually falling. It actually turned negative in 2020. In other words, with a low term premium, it has become much easier to see a negative 10–2 yield spread without it triggering a recession. The yield spread turned negative in July 2022 and reached a trough in June 2023. Currently, it is nearly positive again, without it triggering a recession thus far.

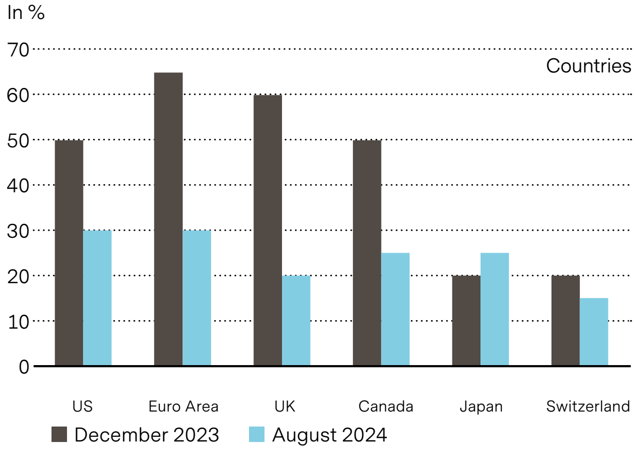
Overall, according to a monthly Bloomberg poll, analysts see the likelihood of a US recession at 30 percent, down from 50 percent at the start of the year. The probability of a recession has also fallen in other countries, with the exception of Japan (see chart 2). That said, there is more evidence that the labor market is indeed slowing in the US. Even though monthly payroll data can be very volatile and can be adjusted substantially as well, the year-over-year change in employment growth has gradually slowed from over 4 percent year-over-year in 2022 to 1.6 percent now (see chart 3). Small business's hiring intentions have also gradually slowed from a high level to one that is close to the long-term historical average. It is expected to slow a bit further. However, according to Jerome Powell, the labor market has slowed enough for the Fed's liking ("We do not seek or welcome further cooling in labor market conditions").

Taking a broad set of economic leading indicators into account, the US still remains on course for a soft-landing. The "landing" is on its way as growth peaked about one year ago and although a recession is not our base case, we cannot completely rule it out either. Nonetheless, if the US is faced with a recession, it will most likely be a mild one. Over the past 11 recessions, as confirmed by the NBER, eight were mild and three were deep[2]. The deeper recessions tend to go hand in hand with a broader crisis, like a banking crisis (1975, 1982, 2008). We currently see no significant macroeconomic imbalances or excessive levels of leverage in the banking sector. For that reason, our view is that the probability of a deep recession is quite low.

Mild recessions tend to be short and shallow (see chart 4) and the economy recovers quickly. That also has implications for financial markets. Equity markets tend to peak before the recession starts and it generally takes quite a few quarters until the NBER officially calls the recession. It is quite possible that equities are already recovering by that time. We therefore advise remaining invested in equities, even in case of a mild recession. High-quality long duration fixed income tends to perform well in a mild and deeper recession and protects against negative growth shocks.

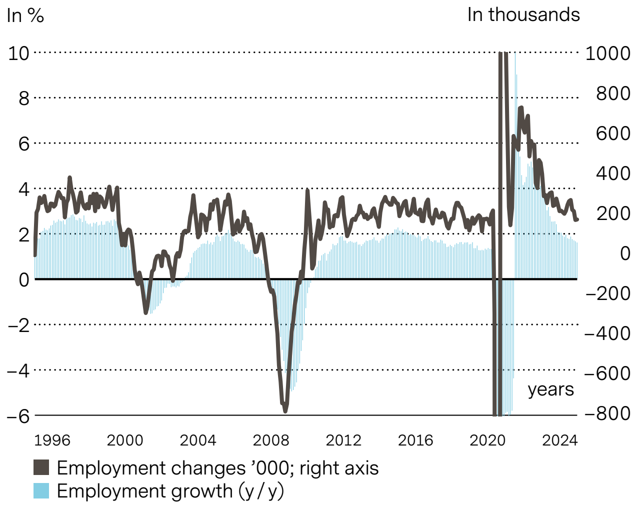
[2] Bordo, M.D. & J.G. Haubrich, 2012, Deep recessions, fast recoveries, and financial crises: evidence from the American record. NBER Working paper 18194

Chart 2: Recession probabilities



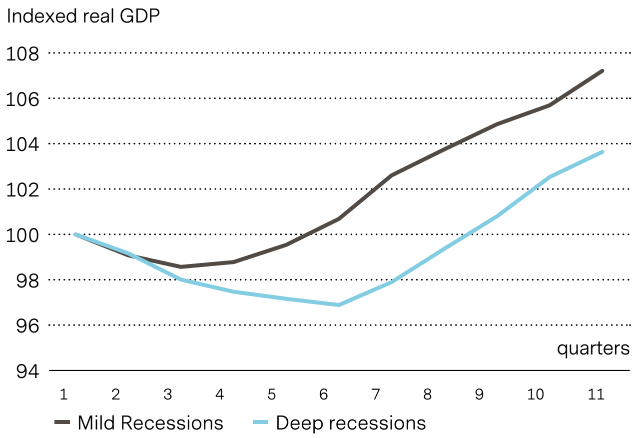
Source: Bloomberg, Vontobel SFA

Chart 3: Employment growth



Source: Bloomberg, Vontobel SFA

Chart 4: Mild and deep recessions in the US



Source: Bloomberg, Vontobel SFA

Getting closer to a first Fed rate cut

—
Philipp Wartmann
Senior Investment Adviser,
Vontobel SFA

The Taylor Rule[3]—a formula that helps central banks balance their goals of controlling inflation and promoting economic growth by providing a guideline for setting interest rates—suggests the US Federal Reserve's rate is currently 1.7 percentage points too high, amid rising unemployment and slowing inflation. With markets volatile and growing expectations of Fed cuts, we maintain our preference for investment grade bonds as monetary policy loosens.

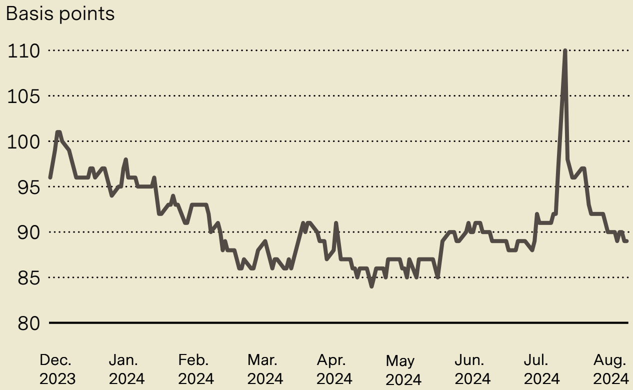
According to the classic Taylor Rule, the current benchmark interest rate set by the Fed is approximately 1.7 percentage points—or equivalent to seven quarter-point cuts—above the appropriate level. This assessment follows an increase in the unemployment rate to 4.3 percent in July and a slowdown in inflation, with the Fed's preferred measure the Personal Consumption Expenditures (PCE) Price Index excluding food and energy rising just 2.6 percent year-over-year in June[4]. Incorporating the Fed officials' estimate of a 0.7 percent "neutral real rate" and a long-run unemployment rate of 4.4 percent, the Taylor rule suggests an appropriate interest rate of about 3.7 percent. It is expected that the Fed will start cutting rates this month.

Greater volatility in global credit markets in August
The unwinding of the yen carry trade at the start of August led to a spillover effect on global credit markets and spreads on the US broader market widened from 90 bps to approx. 110 bps (see chart 1), a level not seen since the end of 2023.

The negative impact on credit markets were short-lived and spreads have recovered to near year-to-date lows, while holding on to gains in the Treasury markets. The broader US IG market's YTW is trading at approximately 4.8 percent, which continues to be an attractive all-in-yield (see chart 2). We acknowledge that spreads are tight versus their long-term averages. However, investment grade credit remains attractive from a fundamental perspective, given our base case of a soft-landing and robust corporate balance sheets. Although we believe that spreads can remain tight for an extended period of time, the risk reward is better in higher rated bonds versus the BBB-rated segment from a relative value perspective.

[3] Introduced by economist John Taylor, the Taylor Rule is a guideline for adjusting the federal funds rate (overnight bank lending rate). It suggests raising the rate when inflation is projected to be above normal and lowering it when GDP growth is expected to be below normal, assuming other factors remain constant.
[4] Source: Bloomberg article, published July 26, 2024. www.bloomberg.com/news/articles/2024-07-26/fed-s-preferred-inflation-gauge-rose-at-mild-pace-in-june

Chart 1: Investment grade spread over government bonds



Source: Bloomberg, Vontobel SFA

Chart 2: Corporate bond yield (BofA ICE Index)

Source: Bloomberg, Vontobel SFA

Equities' rollercoaster ride

—
Markus Bruhin
Head Managed Solutions,
Vontobel SFA

This summer took investors on a rollercoaster ride. Europe faced stormy weather and Hurricane Beryl ravaged the Caribbean and the US Gulf Coast. Similarly, after reaching an all-time high by mid-July, stock markets encountered a perfect storm in an already weak seasonal period, leading to a spectacular global sell-off. Equities corrected in early August but rebounded quickly. Where might markets go from here?

July saw plenty of headlines on the US presidential election, and escalations in the Middle East and Eastern Europe conflicts. By mid-July, investor sentiment was dampened by recession fears on the back of some weak US data, a softer-than-expected second-quarter reporting season, high expectations from a strong first half-year and stretched valuations. Uninspiring comments from large US tech companies about the longer-than-expected time to monetize AI investments and sustained capital expenditures ignited a rotation out of tech leaders into small caps and value stocks.

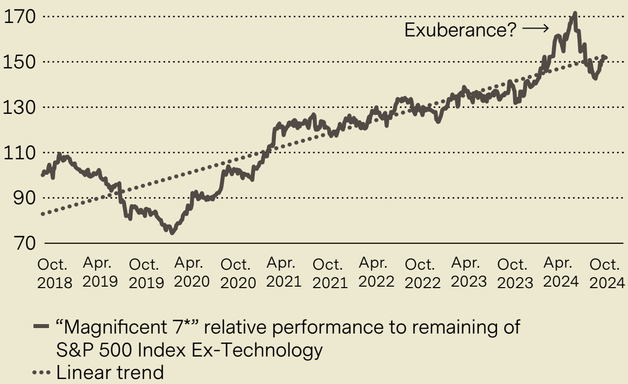
Disappointing US job figures raised fears that the Fed was again behind the curve in cutting rates, reviving recession concerns. Combined with a surprise rate hike from the Bank of Japan, this triggered a massive unwinding of leveraged yen positions, creating perfect storm conditions. The resulting global sell-off affected risky assets, particularly equities, with "fear gauges" such as the Chicago Board Options Exchange's Volatility Index (VIX) reaching levels only surpassed by the 2008 Lehman Brothers collapse and the 2020 Covid-19 outbreak. The intraday reversal that followed was one of the most dramatic in history.

Given the record-breaking performance in the first half of 2024, extreme bullish positioning, rich valuations and ambitious earnings expectations for US tech stocks, a correction seemed imminent. The market shake-up last month has been beneficial for market breadth, with the exuberance of mid-July now under control (see chart 1). In fact, we view this recent correction as a healthy consolidation within a longer-term uptrend.

Historically, a correction of up to 10 percent is not unusual, even more so given the traditionally weak seasonal period (see chart 2). Additionally, US large cap companies have emerged from their buyback blackout period, which should support the market. With technical concerns now addressed, the focus shifts to fundamentals. In addition, following Powell's speech at Jackson Hole, the Fed's rate cutting cycle is now likely to "begin" in September if data continue to come in as expected. Furthermore, growth and earnings momentum remain strong, as evidenced by the latest reporting season and corporate outlooks.

Chart 1: Magnificent exuberance

Relative performance in %, indexed to October 15, 2018 (=100), in USD

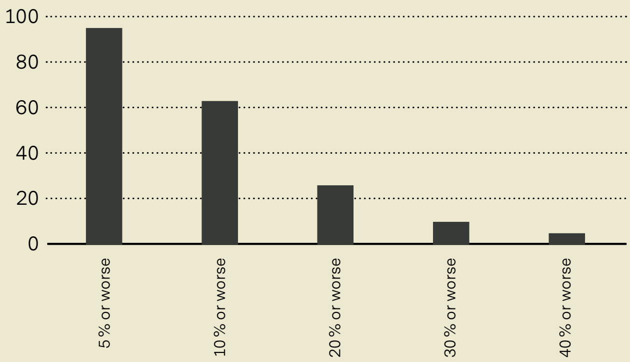


* Magnificent 7: Nvidia, Apple, Microsoft, Alphabet, Amazon, Meta, Tesla

Source: Bloomberg, Vontobel; data as of August 23, 2024.

Chart 2: Probability of stock market pullbacks over the last century

Probability per year in %



Source: Bloomberg, Vontobel; data as of August 23, 2024.

Commodities' performance sluggish but mixed (across sectors)

—
Christoph Windlin
Deputy Head
Investment Management,
Vontobel SFA

The year 2024 has been mixed for commodities. After an initial rally at the start of the year, the Bloomberg Commodity Index has returned to where it was in December 2023 (see chart 1).

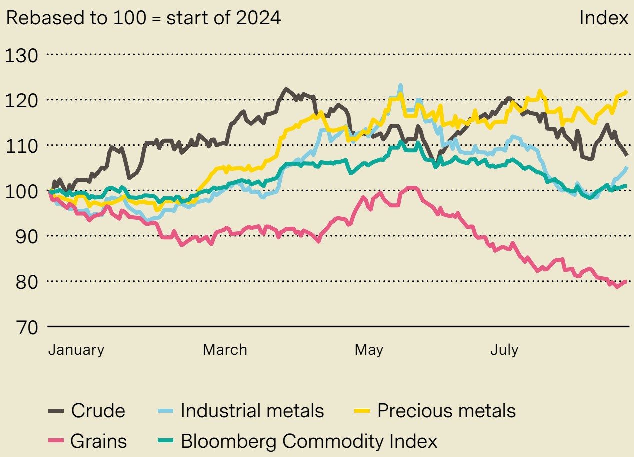
The different commodity sectors have diverged significantly. The laggard has been agricultural commodities. Agricultural commodities, which make up almost 27 percent of the index, have struggled with bumper harvests (oversupply). Base metals, accounting for just under 16 percent of the index, have been weighed down by subdued industrial demand and economic uncertainty in China, a major metals consumer.

While oil prices were initially buoyed by geopolitical factors and seasonal demand, the outlook appears less rosy. China, the world's largest oil importer, is reducing imports. With the driving season coming to a close and inventory draws tapering off, even OPEC and its allies (OPEC+)—which are typically bullish+)—have cut their global oil demand forecasts[5]. A lot now hinges on OPEC+'s future production policies. OPEC+ is currently withholding around 5.7 percent of global supply but plans to gradually return 2.2 million barrels per day to the market in the fourth quarter. However, given the uncertain demand outlook, it remains to be seen if these cuts will be reversed. In the absence of major shocks, WTI crude oil prices are likely to stay between USD 70 to USD 80 per barrel. With OPEC's recent forecast cuts, partly driven by China's economic situation, further production cuts may be on the horizon to support prices.

Following on from 2023, 2024 is another strong year for gold so far. Gold makes up 17 percent of the broad Bloomberg commodity index. After an already impressive rally, the precious metal reached a new all-time high of over USD 2,500 per ounce in August. Interestingly, the factors that have driven gold demand in the recent past)—such as central bank and emerging market demand)—seem to be losing their importance. Markets shrugged off news that the People's Bank of China had paused its gold reserve accumulation and remained unfazed by reports of a decline in Chinese gold imports for non-monetary purposes in July[6]. Instead, traditional macroeconomic drivers such as US real yields and the US dollar have returned to center stage (see chart 2). As we see it, our expectation for lower US real yields and a weaker US dollar argue in favor of maintaining a slight overweight in gold versus other commodities, while remaining overall neutral in commodities.

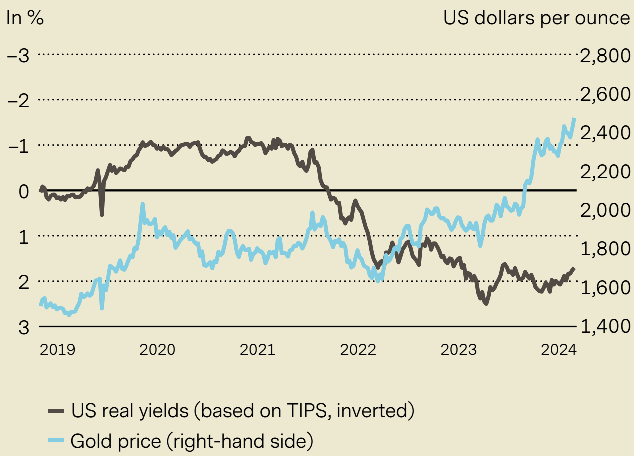
[5] Source: Reuters article, published August 12, 2024. www.reuters.com/business/energy/opec-cuts-2024-oil-demand-growth-forecast-citing-china-2024-08-12/
[6] Source: Bloomberg article, published August 20, 2024. /www.bloomberg.com/news/articles/2024-08-20/china-s-gold-imports-tumble-again-as-record-prices-deter-buyers

Chart 1: "Back to December" for commodities



Source: LSEG, Bloomberg, Vontobel; data as of August 22, 2024.

Chart 2: Macro matters again



Source: LSEG, Vontobel; data as of August 22, 2024.

Euro-dollar prospects brighten as franc stability faces tests

—
Dr. Pieter Jansen
Chief Investment Strategist,
Vontobel SFA

Disappointing US economic data has lifted expectations of faster US Federal Reserve easing, which pushed the EUR / USD through 1.10. In Switzerland, a strong franc challenges exports, which may lead the Swiss National Bank (SNB) to consider further rate cuts to curb the currency's rise amid limited interventions.

Euro-dollar bulls have been bolstered by recent disappointing US economic data, which has fueled expectations of faster easing by the Fed (see chart 1). This pushed the euro-dollar through USD 1.10. However, the strength and duration of any rally will also depend on a resurgence in global risk appetite, positive developments in the Eurozone and of course the evolution of US economic data going forward. Continued improvement in the eurozone's economic environment could narrow the current and expected euro-US growth differential, supporting a longer-term break of the USD 1.10 mark. From a medium-term perspective, the euro remains slightly undervalued versus the dollar.

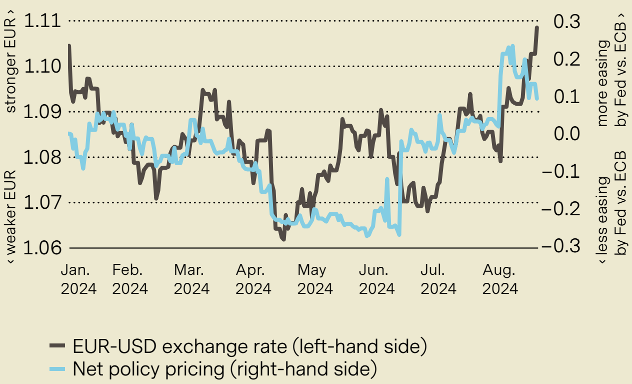
Swiss economy at the mercy of the mighty franc

The Swiss economy, which is heavily reliant on exports—evidenced by a 74 percent export-to-GDP ratio in 2023, according to the State Secretariat for Economic Affairs—is highly sensitive to currency fluctuations. With inflation concerns easing, the strong franc could pose challenges for exporters, particularly small and medium-sized businesses. Swissmem, the leading advocacy group for manufacturers in the country, has recently urged the SNB to intervene, cautioning that the strong franc is detrimental to the economy.

In Switzerland, core inflation fell below two percent in May 2023 and stood at 1.1 percent in July. Coupled with the tightening effects of a stronger currency, this has reignited expectations for rate reductions by the SNB in September. The SNB began its easing cycle with a 25-basis point cut in March, followed by another 25-basis point cut in June. Bloomberg Economics anticipates further cuts of 25 to 50 basis points by year's end. While these measures may limit further appreciation of the franc, they are unlikely to significantly alter the course of its rally, which is driven by global market uncertainties. August once again showed that the franc benefits from investors looking for a safe haven during times of uncertainty.

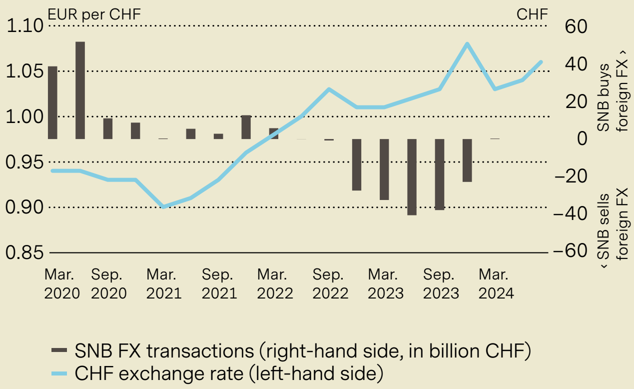
Although foreign exchange intervention remains a possibility, the SNB has been relatively inactive in this area this year, having acquired only CHF 281 million in foreign reserves in the first quarter (see chart 2).

Chart 1: US rate expectations take a turn



Source: Bloomberg, Vontobel; data as of August 19, 2024.

Chart 2: SNB's quiet quarter: minimal intervention despite potential market moves



Source: Bloomberg, Vontobel; data as of August 19, 2024.

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	3.0	3.0	2.5	2.6
Eurozone	3.4	0.4	0.6	0.7	1.4
USA	1.9	2.5	3.1	2.3	1.7
Japan	1.0	1.9	–0.8	0.1	1.2
UK	4.5	0.3	0.3	1.0	1.3
Switzerland	2.7	0.7	0.8	1.3	1.4
Australia	3.8	1.9	2.1	1.2	2.1
China	3.0	5.2	4.7	4.9	4.5

INFLATION	2022	2023	CURRENT[2]	2024 CONSENSUS	2025 CONSENSUS
Global (G20)	7.5	4.4	5.6	4.9	3.1
Eurozone	8.4	5.5	2.6	2.4	2.1
USA	8.0	4.1	2.9	3.0	2.4
Japan	2.5	3.3	2.8	2.4	1.9
UK	9.1	7.3	2.2	2.6	2.2
Switzerland	2.8	2.2	1.3	1.3	1.1
Australia	6.6	5.7	3.8	3.4	2.8
China	2.0	0.2	0.5	0.5	1.5

KEY INTEREST RATES (IN %)	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR	2.50	4.50	4.25	3.40	2.65
USD	4.50	5.50	5.50	4.75	4.00
JPY	–0.10	–0.10	0.23	0.35	0.59
GBP	3.50	5.25	5.00	4.65	3.75
CHF	1.00	1.75	1.25	0.95	0.89
AUD	3.10	4.35	4.35	4.30	3.70

GOVERNMENT BOND YIELDS, 10 YEARS (IN %)	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR (Germany)	2.6	2.0	2.25	2.26	2.23
USD	3.9	3.9	3.85	4.03	3.92
JPY	0.4	0.6	0.90	1.10	1.30
GBP	3.7	3.5	3.96	3.80	3.63
CHF	1.6	0.7	0.45	0.62	0.84
AUD	4.1	4.0	3.92	4.09	3.91

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	0.99
CHF per USD	0.94	0.84	0.85	0.88	0.89
CHF per 100 JPY	0.72	0.60	0.58	0.60	0.62
CHF per GBP	1.12	1.07	1.12	1.13	1.16
USD per EUR	1.06	1.10	1.11	1.10	1.12
JPY per USD	130.00	141.00	146.00	148.00	143.00
USD per AUD	0.67	0.68	0.67	0.68	0.69
GBP per EUR	0.88	0.87	0.85	0.85	0.85
CNY per USD	6.91	7.10	7.14	7.20	7.16

COMMODITIES	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
Brent crude oil, USD per barrel	86	77	78	83	81
Gold, USD per troy ounce	1,824	2,063	2,499	2,400	2,500
Copper, USD per metric ton	8,372	8,559	9,131	9,900	9,990

[1] Latest available quarter
[2] Latest available month, G20 data only quarterly
Source: Vontobel, respective statistical offices and central banks; as of August 23, 2024

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