Vontobel

US Investors' Outlook

Looking at the big picture

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Looking at the big picture

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

Central banks' actions, inflation and risks of a recession have captivated investors' attention for several months now. And while uncertainties remain, the view ahead seems to be clearing slowly. It's a good time to step back and highlight the bigger picture.

The economic picture looks as if monetary policy tightening has stabilized and is tilting towards a pause as we move to the second half of the year, accentuated by declining inflation levels and increasing signs of further decelerating economic activity ahead. This has been our expectation all along.

Our scenario analysis is currently based on a solid framework and our base case scenario assumes that economic activity is quite unlikely to accelerate again in the foreseeable future. For this reason, we have made no changes to our asset allocation this time. Overall, we do not consider it an opportune moment to take on additional equity risk. We maintain an equity exposure close to the strategic allocation weight. In search of attractive risk-adjusted returns, emerging market debt (EMD) offers a source of excess returns and investment grade corporate bonds are as well on our favorite list.

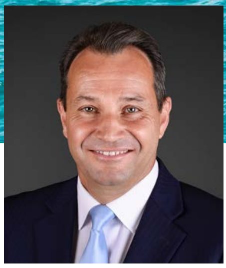
The Group of Seven (G7) nations, which make up the world's major democratic economies, have softened their tone around Chinese relations, emphasizing de-risking without decoupling from China. This evolution reflects their attempt to strike a more diplomatic approach to China's rise and its importance for global supply chains and the economy.

With all eyes on economic indicators from China, the world's growth engine, some investors may be concerned about a waning post-pandemic recovery. While the initial spike we saw in the country's property markets and construction sectors is already softening, we see the longer-term trend tilting upwards as the rebound is consumer driven. While the recovery may not be happening as fast as many had hoped for, and some months may be weaker than others, it's moving in the right direction. The accumulated cash during the time of zero covid policy will create additional consumer demand. That's already been good news for European companies and US companies, which have tremendous exposure to Chinese consumers. Also, part of the bigger picture is the opportunity for investors with a long-term time horizon to use the overvalued USD and invest in international markets. Reducing the US home bias and maybe even reduce the exposure to IT sector can be a reduction to very high level valuations.

Speaking of the love of spending, in this edition of our Investors' Outlook, you can read our assessment of the environment for US consumers and why we see that space weakening and lowering inflation with it. We also discuss gold and why the rally still has some room to run, as well as what might be next for the US dollar.

We're not losing sight of the bigger picture. We are looking at what matters and showing you what we see.

Best regards,
Pascal



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Navigating the fog

A sequence of supply and demand shocks in the aftermath of the Covid-19 pandemic has driven inflation to levels not seen in several decades, forcing central banks to change course to avoid a collision and the risk of a potential death trap. Central banks tightened their monetary policy robustly and quickly. Recessionary and even stagflation concerns drove down risk assets, resulting in double-digit negative returns on both bonds and equities.

Monetary policy can already celebrate its first achievements, with inflation peaking in late summer 2022 in the US and during the first quarter 2023 in the euro area (EA). Since then, inflation, in particular energy and goods inflation, continued to fall gradually. At the same time, economic activity lost steam, especially in EA, while tight labor market conditions and pent-up demand in the US continued to support domestic demand and economic expansion. The late reopening of the Chinese economy and flat expansion path of world trade have proven to be a severe burden for the more export-oriented EA economy, resulting in a significant deceleration of EA GDP growth. While we can expect to see a pause in rate increases in the US, persistent core inflation in the EA will likely force the European Central Bank (ECB) to stick to its current tightening policy, albeit with a slower pace of rate hikes. A further deterioration of financial conditions and lending standards may continue to weigh on credit demand and therefore on private consumption and investment spending.

Against this economic backdrop, we remain reluctant to add further risks to our portfolios and will maintain an equity exposure close to the strategic allocation weight. Although the economic downturn is losing momentum, the recovery remains rocky. Earnings have surprised on the upside, but with inflation starting to fade, mark-ups should soon start to decline. We therefore do not express any regional equity preferences and reiterate our neutral allocation to our major equity regions, including emerging market equities.

We are keeping our overweight allocation to global fixed income. With falling inflation, the inflation premium embedded in bond yields may also decline. Although there is limited potential for spread compression, we are overweight investment grade corporate bonds, which offer fair value yield pick-ups over government debt. On the other hand, non-investment grade corporate debt does not deliver a risk-adjusted attractive expected return, which justifies our underweight allocation. Emerging market debt (EMD) denominated in local and hard currency remains our most preferred asset classes, as it provides attractive valuations.

	UNDERWEIGHT significantly	UNDERWEIGHT slightly	NEUTRAL	OVERWEIGHT slightly	OVERWEIGHT significantly	
1 Liquidity		→				We continue to underweight cash, as the expected returns on equities and especially on bonds have improved significantly since the end of quantitative easing and the start of the central banks' fight against inflation.
2 Bonds				→		We are sticking to a moderate positive view on fixed income and reiterating all sub-asset class views. We are maintaining our positive view on government bonds. The more attractive yield levels will encourage inflows into safe assets as inflation continues to abate, therefore reducing the inflation risk premium. We remain overweight in investment grade (IG) credit, as most bond issuers have solid balance sheets and should cope with a shallow slowdown. We remain underweight in high yield bonds due to rising recession probabilities and our outlook for the US economy. Lastly, we are also staying positive on emerging market debt benefiting from a weakening USD.
3 Equities			→			Central banks continue to curb inflation—at the expense of employment and economic growth—especially in EA where core inflation proved to be more persistent than expected. As the economic downturn is losing momentum but recovery remains rocky, the risks of a global recession have started to recede. The probability of a significant deceleration of the US economy in 2023 is slowly declining. However, the equity multiples that compare the current equity market drawdown with past drawdowns clearly show that markets have already priced in much of the above. In the absence of a broad-based, global recession, we therefore believe that an allocation to equities close to the strategic weight is still appropriate. We are therefore not adding any further risk assets to our portfolios. At this stage of the cycle, we do not express any regional equity preferences. We also have a neutral allocation to emerging market equities.
4 Commodities / Gold				→		We are keeping an overweight allocation to gold, as it has been a systemic portfolio diversifier during times of rising market stress. As the global economy increasingly loses momentum, we confirm our general underweight allocation to other commodities, including energy

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

When has the US consumer consumed enough?

Pandemic, inflation, banking crisis, debt ceiling debate – the last three years have truly been full of negative events. However, US consumers have remained resilient. They continued to consume diligently, keeping the economic engine humming. Even so, there are now increasing signs that they will soon have to tighten their belts.

—
Dr. Olaf Liedtke
Chief Investment Strategist,
Vontobel SFA

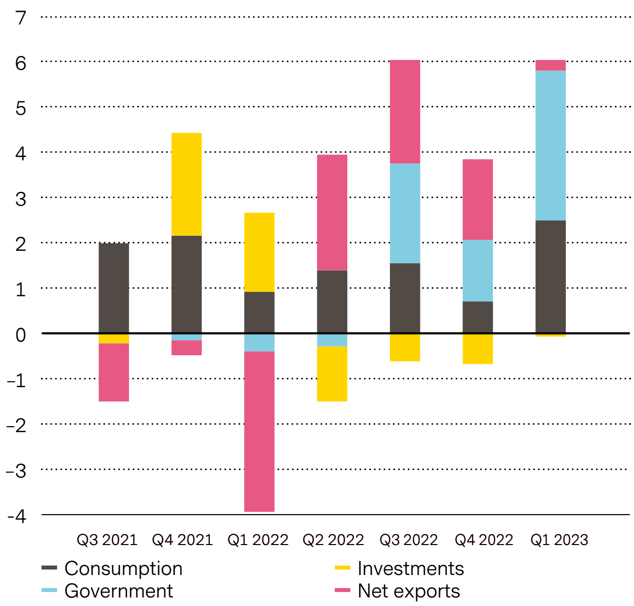
The big question before the release of US gross domestic product (GDP) for the first quarter (Q1) was whether the world's largest economy would finally contract, paving the way for the most anticipated recession ever. Once again, the answer was "no". While economic growth more than halved, US consumers rushed to the rescue, preventing a hard landing (see chart 1).

Strong demand for goods meets subdued demand for services

This resilience is remarkable but far from straightforward. At the start of the Covid-19 pandemic, real consumer spending plummeted. A combination of generous stimulus measures, accumulated savings and pent-up spending appetite then saw consumers happily pull out their wallets again. Even lower real wages because of higher inflation did not dampen expenditure. Real consumer spending has now returned to the growth trend seen before the pandemic. A breakdown of spending shows that demand for consumer durables (such as automobiles, televisions, clothing or jewelry) is significantly higher today than before the pandemic, while demand for services (such as public transportation, dental treatment or leisure activities) has not yet caught up. It's also worth noting that US consumers' largest monthly expense is their mortgage and many have locked in favorable 30-year fixed rates. This has contributed to the resilience of US consumers amid negative events.

Chart 1: A strong US consumer to the rescue

Key contributors to US real GDP growth*

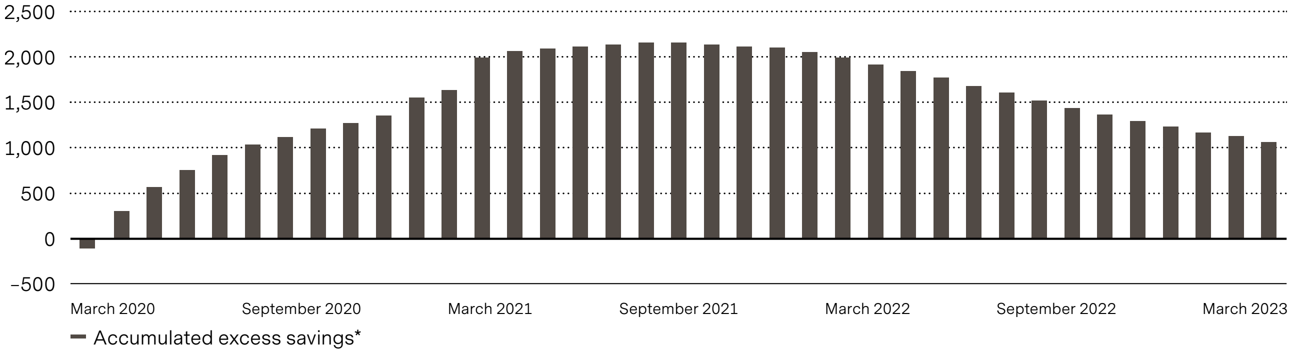


* Excluding inventory change, QoQ % change (annualized)

Source: Refinitiv Datastream, Vontobel

Chart 2: Consumers' accumulated excess savings are still elevated

In bn USD



* Actual savings versus pre-pandemic trend

Source: Refinitiv Datastream, Vontobel

Time to tighten the belts?
In the short to medium term, private consumption could still have some room to run. Declining inflation levels are likely to have a slightly positive impact on purchasing power and consumer savings are still high (see chart 2).

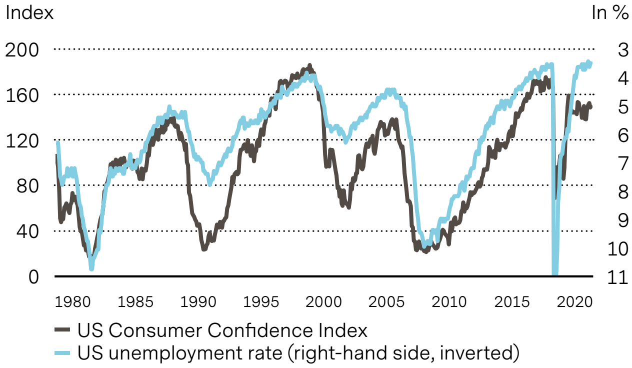
However, private consumption is poised to weaken in the longer term. This is due to several factors. First, demand for consumer durables cannot grow above trend forever. At some point, all goods will have been replaced; the average consumer needs one, at most two cars—but not three or four. Second, it is questionable whether the demand for services will return to trend levels in the foreseeable future due to the increase in working from home or the avoidance of crowds, for example. Third, real consumer spending still exceeds real income. This means that Covid-19 savings will dwindle further in the coming months.

At the same time, data from the Federal Reserve Bank of New York shows that consumers are increasingly resorting to borrowing. Consumers normally accumulate credit card debt at the end of the year, especially during the holiday season, and then reduce it again at the start of the new year. This was not the case in Q1 2023, the first time in two decades; balances remained flat at USD 986 billion. This is not sustainable in the long run, especially considering the current average annual percentage rate on credit cards (20.9%). Such outstanding payments sound the alarm bell. While the overall delinquency rate remains low at 2.6%, the share of debt at least 30 days past due is rising for most types of loans, particularly credit cards (6.5%) and auto loans (6.9%).

When the US labor market slows, consumer spending usually follows suit

When will this happen? Possibly if the US economy experiences a severe downturn with significant layoffs and increasing job uncertainty (see chart 3). In 2008, for example, the recession kicked in as soon as the labor market tanked and unemployment soared. This led to a decline in consumption growth, among other things.

Chart 3: Consumer sentiment depends heavily on how many people have jobs



Source: Refinitiv Datastream, Vontobel

Collecting credit spreads in a prudent manner

—
Matthias Ribback
Portfolio Manager,
Vontobel SFA

Since the beginning of 2023, 10-year government bonds yields have remained almost unchanged in the US and the Eurozone, while moving consistently lower in Switzerland. As central banks are in the process of reversing their quantitative easing to combat inflation, the market for government bonds is increasingly following fundamental economic realities.

In an environment of slow growth and receding inflation, we continue to overweight investment grade corporate debt. Credit spreads offer reasonable compensation for the increased risk of holding corporate instead of government debt.

Government finances and inflation are two important pillars that drive sovereign borrowing costs
Switzerland's debt to GDP ratio of 39% and year-on-year CPI inflation of 2.6% make it a very sound borrower in its own currency, the Swiss franc. The Swiss government can currently issue new 10-year debt at a yield of less than 1%. Germany, Europe's industrial powerhouse, can also boast solid finances with a debt to GDP ratio of 66%. However, inflation in Germany remains elevated at 7.6% year-on-year. German 10-year government debt currently yields 2.4%. The US has just emerged from a political battle to raise the debt ceiling and currently pays a yield of 3.7% on its 10-year government debt. The US debt to GDP ratio stands at 129%, while year on-year inflation of 4.9% was recorded for April 2023.

Inverted yield curves are hard to flatten in the absence of a recession
Despite their different state finances and 10-year yield levels, the US, Germany and Switzerland all show inverted yield curves. The 2y / 10y spread in the US has been negative since November 2022, essentially signaling a recession that has been repeatedly deferred. The culprit is a stubbornly tight labor market and resilient consumer spending. In our opinion, the yield curve inversion will gradually fade as inflation normalizes, the economy slows down and central banks can lower their short-term interest rates. Whether an actual recession with a sudden spike in unemployment will happen is unclear to us and we don't think it is a prerequisite for bringing yield curves back to their normal, upward sloping shape. However, an economic slump would speed up the process by giving central banks a reason to cut rates sooner rather than later.

Chart 1: Inflation

Year over year change in the Consumer Price Index in %

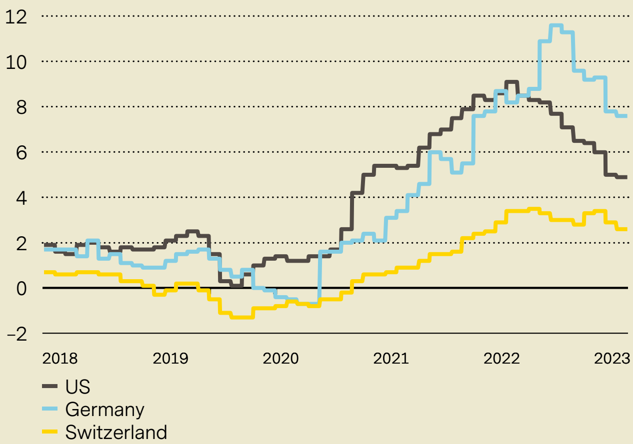
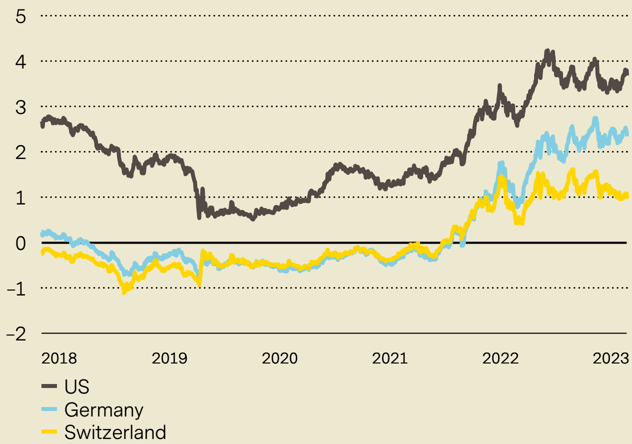


Chart 2: 10-Year Government Yields

Yield to Maturity in %



Wait and see

—
Markus Bruhin
Head Managed Solutions,
Vontobel SFA

Equity markets have continued their positive progression, supported by a better-than-expected reporting season in the US and Europe. This has led analysts to change their expectations, with most of them now having raised the consensus on their full-year estimates, spanning across most markets and sectors.

In developed markets, one impressive characteristic so far this year has been the lack of breadth at index level, with a small number of equities accounting for most of the year-to-date performance. In the US (see chart 1), the top eight companies, which are mostly in the technology sector, had the greatest impact on the index performance. In Europe, twenty stocks drove indices higher. These companies are linked to the technology and consumer goods sectors, especially luxury goods. Most of the remaining constituents in those indices barely performed.

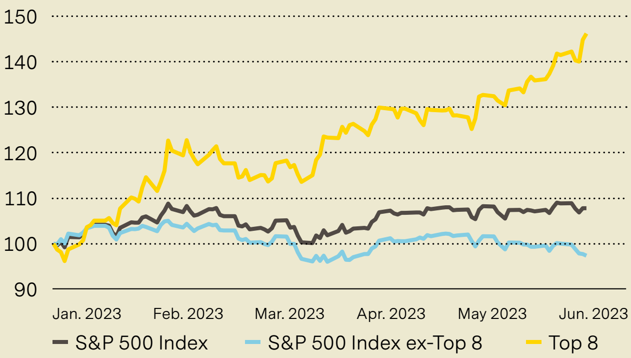
It is hard to analyze markets these days without considering the growing polarization that has occurred over the last few years. This makes it tricky to compare historical cycles with equity markets and could lead to wrong investment conclusions. This is because markets today differ structurally from just 15 years ago (technology stocks now dominate in the US, while almost 40 % of the eurozone's profitability and market capitalization comes from technology and consumer companies). On average, companies are less leveraged with lower debt burdens, have better cashflow generation and therefore offer better earnings visibility. These changes are reflected in rising equity markets in developed countries.

Since March 2009 and shortly after the outbreak of the Covid-19 crisis, US indices strongly outperformed their European counterparts. However, European equities started to outperform their US peers in August 2020. This is not only true on an index level. EPS growth is also much stronger and valuations measured in price-to-earnings (P / E) ratios are consistently lower. The remarkable increase in profits can be attributed primarily to the shift in macroeconomic conditions that have now become favorable. Inflation and the upward trend in commodity prices have played a significant role in driving substantial growth in both revenue and net income margins. In addition, European companies operate on a much greater global scale than their US peers (see chart 2). The Chinese and Asian reopening story offers attractive opportunities in the medium to long term. Inflation rates should drop further and was there an energy crisis?

Despite these positive signs for an overweight in European equities, our positioning remains unchanged. Tighter financial conditions, tougher lending standards and deteriorating leading indicators would have to improve before we change our view.

Chart 1: S&P 500 performance driven by eight large stocks

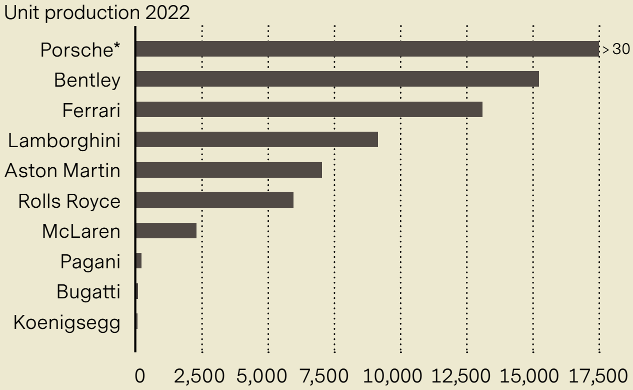
YTD performance of the S&P 500 Index (indexed Jan 1, 2023)



Source: Refinitiv Datastream, Vontobel

Chart 2: Exclusive luxury cars: scarcity spurs desire

Unit production 2022



* Unit production with retail prices > EUR 150,000

Source: Vontobel estimates, Company reports

A challenging backdrop for commodities

—
Christoph Windlin
Deputy Head
Investment Management,
Vontobel SFA

Commodity markets have experienced a volatile first half-year (see chart 1).

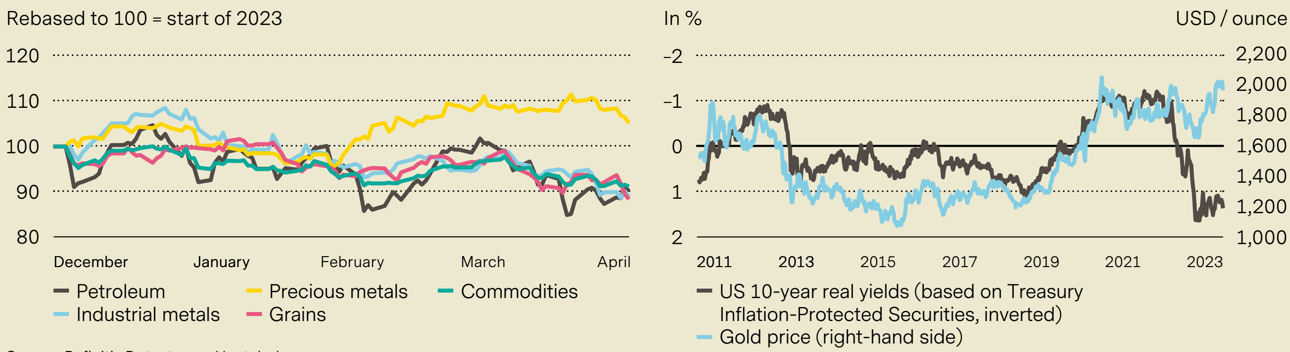
Oil has had to contend with some headwinds
According to the International Energy Agency, Russia produced 9.6 million barrels per day in April alone, "only" 200,000 fewer than before the announced 500,000 barrel-per-day cut. It appears that Russia is trying to make up for lower prices with higher volumes. Other sanctioned countries—Iran and Venezuela—have also produced more than expected. If the Organization of Petroleum Exporting Countries and its allies (OPEC+) manage to fully implement the announced production cuts, this would support oil prices. The US plan to refill its Strategic Petroleum Reserve (albeit by only 3 million barrels) and seasonal conditions should also have a supportive effect. The oil price should be further supported by the cut in oil production announced by OPEC+.

A closer look at metals
While industrial metal copper had a strong start to the year, investors' initial euphoria evaporated following disappointing Chinese economic data recently—especially data on the real estate market, which failed to meet expectations.

However, other metals were able to shine. This was first and foremost gold, which seemed to effortlessly break through the psychologically important USD 2,000 mark. This was not only due to ongoing recession worries but also to the resurgent debt-ceiling debate in the US, which fueled fears of a default of the world's largest economy. It is also interesting to note that gold remains decoupled from US real yields, which we have observed since early 2022 (see chart 2). In the past, gold and real yields were inversely correlated, meaning that the price of gold rose when real yields declined and vice versa. One possible reason for the decoupling could be increased central bank demand. Central banks in emerging markets started to diversify their reserves after sanctions were imposed against Russia's central bank. Going forward, the yellow metal could have some more room to rally. The end of the Fed's rate hiking cycle and all that accompanies it (e.g. a lower USD) have supported gold historically.

Chart 1: A wild ride for last year's high flyer

Chart 2: Gold and real yields have decoupled since early 2022



Source: Refinitiv Datastream, Vontobel

Source: Refinitiv Datastream, Vontobel

The Fed may shape the USD course

—
Dr. Pascal Köppel
Chief Investment Officer,
Vontobel SFA

Tighter credit conditions in the US because of tighter financial conditions due to the anti-inflation policy stance are increasing the likelihood of a severe economic downturn and may propel expectations of a deeper Fed rate easing cycle. These developments bolster the case for a weaker USD.

The USD continues to face headwinds. Growth and interest rate differentials are becoming less supportive and it's possible that US economic data will deteriorate in the coming months. This will only serve to exacerbate this trend. Growth prospects could be further hampered by tighter credit conditions brought on by stress in the US regional banking sector.

The course of the USD may be shaped by the Fed's decisions. The latter now has more to consider with the recent bank turmoil and prospect of tighter financial conditions due to stricter credit rules and higher policy rates. Now that the Fed has essentially indicated a pause in the rate tightening cycle, the divergence in monetary policy between the Fed and other developed market central banks will likely pave the way for more USD weakness (see chart 1). Investors' ongoing anxiety is also poised to lead to wider USD trading ranges.

EUR set to strengthen

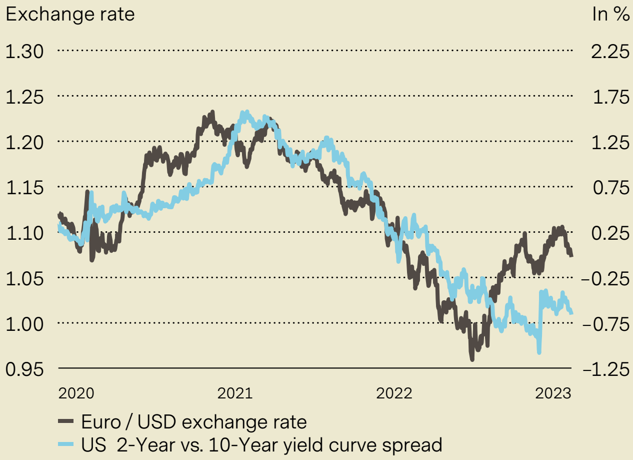
The European Central Bank (ECB) is in a similar situation to the Fed but is further ahead on its path towards policy normalization through rate increases. Like the Fed, the ECB has suggested its desire to slow down the pace of rate increases. However, data has challenged this thesis, as inflation has peaked but is not falling as quickly as desired. Meanwhile, the labor market remains resilient.

On a positive note, the energy situation is set to be less negative in the near term and the global growth backdrop should be supportive, driven by a better outlook for China. As the market contemplates the next phase of the cycle in the US, we can expect the US yield curve to normalize in the medium term. All of this is consistent with the view that the likelihood of a stronger EUR versus the USD has increased, especially as the USD appears to be overvalued based on its effective exchange rate. (see chart 2).

Chart 1: The dollar retreats

Source: Bloomberg, Vontobel

Chart 2: Steeper US yield curve means more euro-dollar upside



Source: Bloomberg, Vontobel

Economy and financial markets 2021 – 2024

The following list shows the actual values, exchange rates and prices from 2021 to 2022 and consensus forecasts for 2023 and 2024 for gross domestic product (GDP), inflation / inflationary expectations, key central bank interest rates, ten-year government bonds, exchange rates, and commodities.

GDP (IN %)	2021	2022	CURRENT[1]	2023 CONSENSUS	2024 CONSENSUS
Global (G20)	5.6	2.6	2.0	2.4	2.3
Eurozone	5.3	3.5	1.3	0.6	1.0
USA	5.9	2.1	1.6	1.1	0.8
Japan	2.3	1.1	1.3	1.0	1.1
UK	8.5	4.0	0.2	0.0	0.9
Switzerland	4.3	2.0	0.8	0.6	1.5
Australia	5.3	3.6	2.7	1.7	1.6
China	8.4	3.0	4.5	5.7	5.0

INFLATION	2021	2022	CURRENT[2]	2023 CONSENSUS	2024 CONSENSUS
Global (G20)	3.5	7.3	6.3	5.3	3.7
Eurozone	2.6	8.4	7.0	5.6	2.5
USA	4.7	8.0	4.9	4.2	2.6
Japan	–0.3	2.5	3.5	2.6	1.5
UK	2.6	9.1	10.1	6.8	2.5
Switzerland	0.6	2.9	2.6	2.5	1.5
Australia	2.9	6.6	7.0	5.6	3.1
China	0.9	2.0	0.1	2.0	2.3

KEY INTEREST RATES (IN %)	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR	–0.50	2.00	3.25	3.7	3.37
USD	0.25	4.50	5.25	5.25	4.25
JPY	–0.10	–0.10	–0.10	–0.09	–0.07
GBP	0.25	3.50	4.50	4.65	4.10
CHF	–0.75	1.00	1.50	1.85	1.64
AUD	0.10	3.10	3.85	3.90	3.65
CNY	3.80	3.65	4.35	4.30	4.25

GOVERNMENT BOND YIELDS, 10 YEARS (IN %)	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS END OF 2024
EUR (Germany)	–0.2	2.6	2.49	2.4	2.08
USD	1.5	3.9	3.74	3.46	3.29
JPY	0.1	0.4	0.40	0.63	0.68
GBP	1.0	3.7	4.12	3.55	3.23
CHF	–0.1	1.6	1.06	1.38	1.19
AUD	1.7	4.1	3.65	3.62	3.31

FOREIGN EXCHANGE RATES	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS END OF 2024
CHF per EUR	1.04	0.99	0.97	1.00	1.01
CHF per USD	0.91	0.94	0.90	0.91	0.91
CHF per 100 JPY	0.79	0.72	0.65	0.71	0.72
CHF per GBP	1.23	1.12	1.12	1.14	1.15
USD per EUR	1.14	1.06	1.08	1.11	1.12
JPY per USD	115	130	138	129	127
USD per AUD	0.73	0.67	0.66	0.70	0.71
GBP per EUR	0.84	0.88	0.87	0.89	0.89
CNY per USD	6.37	6.91	7.05	6.75	6.70

COMMODITIES	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
Brent crude oil, USD per barrel	79	86	77	87.5	89
Gold, USD per troy ounce	1,829	1,824	1,959	1,960	2,000
Copper, USD per metric ton	9,720	8,372	8,128	8,800	8,991

[1] Latest available quarter
[2] Latest available month, G20 data only quarterly
Source: Vontobel, respective statistical offices and central banks; as of May 23, 2023

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