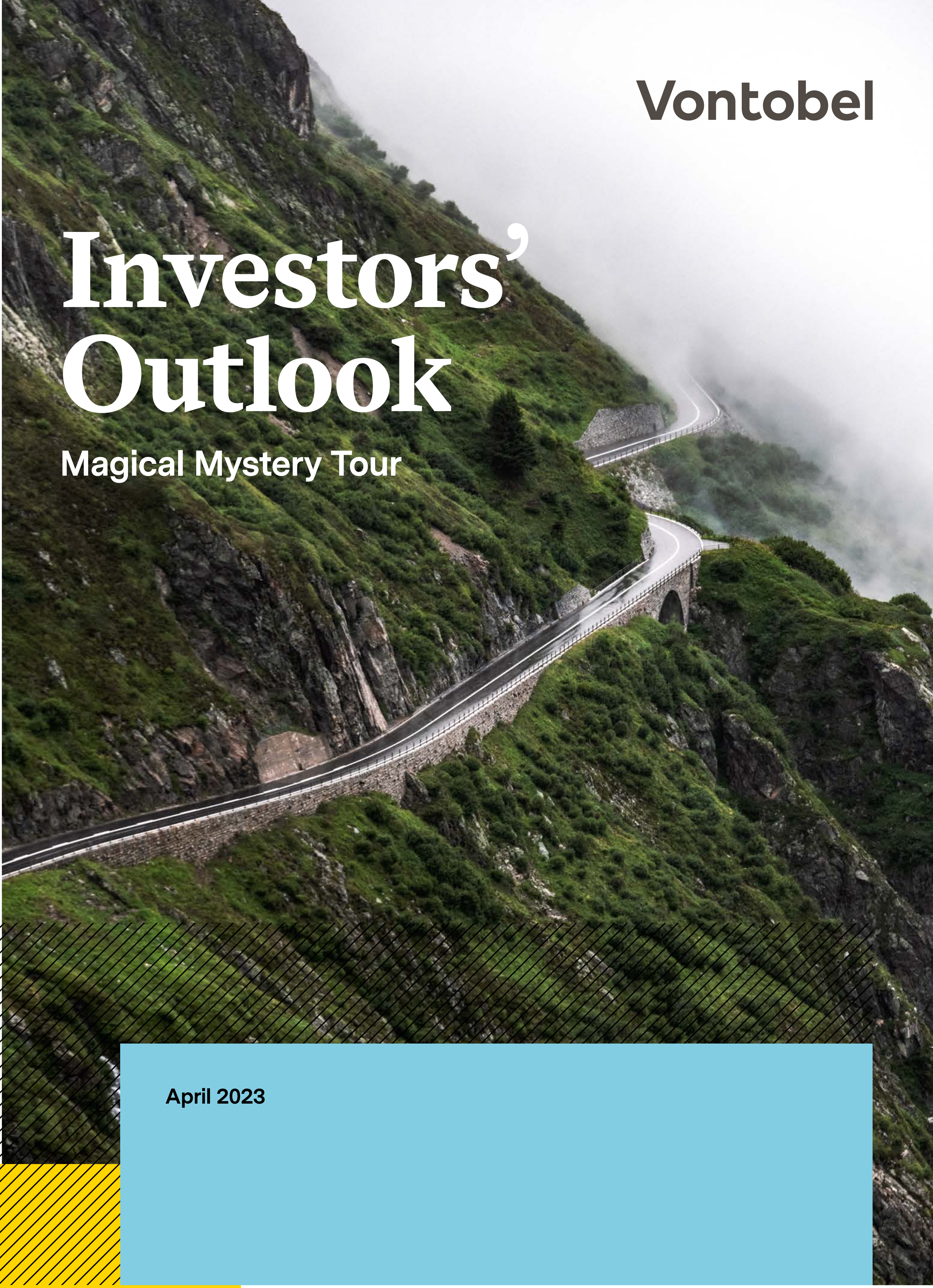

Vontobel

Investors' Outlook

Magical Mystery Tour

April 2023

Vontobel Swiss Financial Advisers AG

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Recession? It is not all about GDP growth

—
Dr. Pascal Köppel
Chief Investment Officer,
Vontobel SFA

Dear readers,

The incubation period between central banks' rate hikes and the first symptoms appearing in the real economy has come and gone.

This month showed that rates can't be increased without something breaking. The first wave of problems in crypto markets rippled over into venture capital, before spilling over into the first real collapse in regulated markets and the banking sector. Contagion fears soared and a loss of confidence momentarily broke out. But courageous measures taken by the US central banks and US bank regulators restored trust again fast. Although idiosyncratic risks in the US banking sector continue to persist, a repetition of the global financial crisis (GFC) is rather unlikely, given the strong regulation and common capital requirements in place for system-relevant banks.

What medicine did we take? Preventative measures were already in place. Cutting risk in our portfolios, going neutral on equities and staying underweight on high-yield bonds proved to to be effectively to protect our clients' assets ahead of the turmoil that March ushered in.

So, what's the prognosis for the global economy? Central banks continue to favor price stability, although the cocktail of a slowing economy and weakening inflation rates makes a further downturn in the advanced economies more probable. Nevertheless, as long as inflation and especially core inflation remain far above the policy targets, any expectation of rate cuts appears pre-mature.

Given the heightened volatility in the markets, we believe it is too early to over extend and pick up perceived opportunities, as the situation could still take a turn for the worse.

In this Investors' Outlook, you will find our take on the most recent developments in the markets and economy. We will take a closer look how the National Bureau of Economic Research (NBER) defines a recession and whether some of these preconditions already indicate recessionary signals. You can also read up on the details of our asset allocations and why we have decided to refrain from any changes.

While we let the dust settle before making a move again, we are keeping a close eye for signs of convalescence.

Best regards,
Pascal Köppel

—
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A fragile recovery

Even though inflation continues to retreat, central banks in the advanced economies will not yet pause their tight monetary policy stance or even cut rates. The battle against inflation remains their topmost priority even if idiosyncratic risks in the banking system may exist or reoccur. More positive signs have now started to appear, which gives us confidence that a severe economic downturn in the advanced economies can be avoided.

Tight monetary policy in the advanced economies further dampened the expansion of domestic demand in late 2022. Global economic activity during the first quarter 2023, however, was better than feared at the end of last year. Purchasing Manager Indices (PMI) moved back into expansionary territory for all major regions, initially driven mainly by the service sectors. Manufacturing is also catching up as supply chain disruptions continue to abate. Labor markets remain tight across almost all G20 economies, supporting private consumption. Headline inflation is falling, but core inflation remains elevated, requiring further measures to bring it down. The economic recovery therefore remains fragile.

An equity exposure close to the strategic weight appears to be appropriate against this macroeconomic backdrop. Even though some economies may master the current and expected economic downturn more successfully than others, we do not express directional positionings across our equity market universe.

We still prefer investment grade corporate bonds, as most bond issuers have solid balance sheets and should cope with a shallow slowdown. We still like local and hard currency denominated emerging market debt offering attractive risk adjusted returns. We are keeping an underweight allocation to non-investment grade corporate bonds We are maintaining the underweight allocation to commodities but are holding an overweight allocation to gold as a portfolio diversifier should the economic outlook darken again.

	UNDERWEIGHT		NEUTRAL	OVERWEIGHT		
	significantly	slightly		slightly	significantly	
1 Liquidity		→				We remain underweight in cash. This gives us leeway if investment opportunities arise.
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			→			The battle against inflation remains paramount for central banks in the advanced economies. They have emphasized several times that current inflation is too far from tolerance and more measures are needed to bring it back to the medium-term targets. As further weakening of domestic demand growth and the occurrence of further idiosyncratic risks in the banking sector cannot be rule out, an equity allocation close to the strategic weight appears to be appropriate, although risks have become somewhat better balanced but remain tilted to the downside. Uncertainty about the course of the war in Ukraine and its broader consequences is a key concern. The strength of the impact from monetary policy changes is difficult to gauge and could continue to expose financial vulnerabilities from high debt. Given the interconnectedness of the global economy, we don't express a preference for a specific equity market.
4 Commodities / Gold				→		We remain overweight in gold even after the strong rise to slightly below USD 2,000 per ounce. Gold has proven to be an efficient portfolio hedge against uncertainty about the future path of the economy and therefore future central bank rates. It correlates negatively with real yields. As inflation is expected to decline further, nominal rates are projected to fall and real rates should decrease. With the momentum of the global economy not expected to gain traction and demand for overall commodities remaining limited, we are maintaining an underweight allocation to broad commodities. The strong appetite of the Chinese economy at the early stage of its reopening process may argue against the underweight in broad commodities. Supply chain distortions, however, have already abated fully to pre-crisis levels, so that additional demand for commodities should also have normalized. Additionally, the pick-up in demand as a result of higher manufacturing activity in China should be absorbed by current prices.

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

It is not easy to define a recession

Risks point to a further deceleration of the economic downturn, suggesting that the advanced economies may well enter into an outright recession. However, this is not our base case scenario that assumes the global economy is strong enough to avoid a recession.

—
Dr. Olaf Liedtke
Chief Investment Strategist,
Vontobel SFA

We admit that the risk for the global economy remains on the downside, even though global economic activity during the first quarter 2023 was better than feared at the end of last year. The global economy has mastered turbulent challenges, digesting an inflation shock not seen in decades, tighter financing conditions as policy makers tried to cool demand to bring inflation back to target and the uncertainty about the sustainability of the reopening process of the Chinese economy.

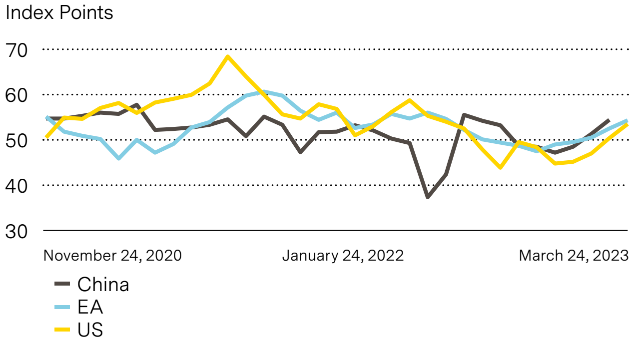
Monthly data released in early 2023 point to a near-term improvement in growth prospects in the largest economies. Activity data in the United States surprised on the upside in January and labor markets remain tight across almost all G20 economies, including in Europe, supporting private consumption. Survey indicators have also strengthened from the troughs seen in late 2022. Consumer confidence has started to improve, and enterprise survey indicators have stabilized or rebounded in all major regions. In February, more firms reported rising rather than falling output in all major economies, with substantial jumps in the US, the euro area, China and the UK according to the Organization of Economic Cooperation and Development (OECD).

The improvement in activity and sentiment in the advanced economies in early 2023 is due to the decline in global energy and food prices. This boosts purchasing power and should help to lower headline inflation. China's reopening is also expected to have a positive impact on global activity. The fall in energy prices partly reflects the impact of the mild winter in Europe, which helped to preserve gas storage levels, as well as lower energy consumption in many countries. The impact of the measures taken against Russian energy exports has also been more limited than initially expected, with Russia largely maintaining export levels by expanding sales in other markets, albeit at substantially discounted prices. Food and fertilizer prices have also come down from their peak last year. These are all encouraging signs that a severe deceleration of economic activity or an outright recession can be avoided. This does not imply, however, that GDP growth in some economies may not drop into negative territory.

The National Bureau of Economic Research (NBER) in the US is the official department that defines whether the US economy has entered a recession. In the past, the NBER defined a recession as negative GDP growth for two consecutive months. The NBER, however, has expanded its analysis in recent years by using a broad basket of indicators of economic activity to define whether the economy has fallen into recession. This basket includes the following economic indicators: real personal income less transfers, non-farm payroll employment, employment as measured by the household survey, real personal consumption expenditures, wholesale-retail sales adjusted for price changes and industrial production. There is no fixed rule as to what measures contribute information to the process and how they are weighted. A further rule to determine whether a recession has occurred is that a recession must influence the economy broadly. From the list of indicators mentioned above, this applies most likely to real personal income less transfers and non-farm payroll employment according to the NBER, not real GDP growth. Non-farm payroll employment is around 3 percent higher than average employment in 2019 and approximately 20 percent higher than the lowest level of employment at the beginning of the Covid-19 pandemic, while real personal income less transfers is approximately 1.5 percent higher than the 2019 average. Based on these numbers, the NBER does not believe a recession is in sight yet.

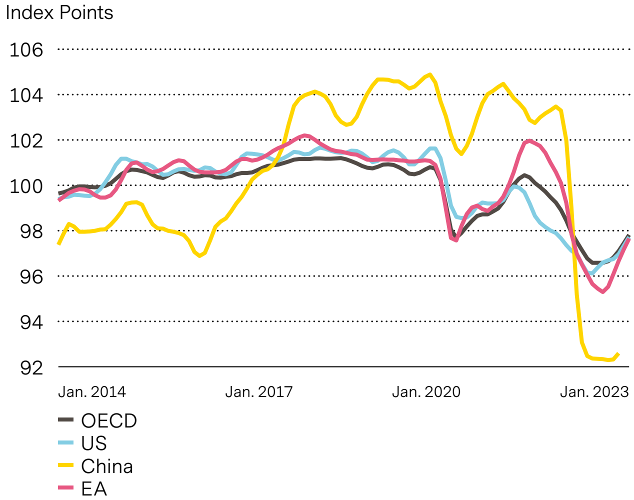
Against this backdrop, US monetary policy is expected to remain unchanged and policymakers may even deploy additional measures. In our view, anticipating rates cuts during the course of 2023 is premature. As core inflation in the euro area remains more persistent than in the US, the European Central Bank will continue to hike rates to push inflation towards the respective policy target.

Chart 1: Purchasing manager indices (PMI Composite)—back in expansionry territory



Source: Bloomberg Finance L. P., Vontobel SFA

Chart 2: OECD Consumer confidence



Source: OECD, Vontobel SFA

Fed funds' path significantly shifts as a result of banking stress

—
Matthias Ribback
Portfolio Manager,
Vontobel SFA

After Fed Chairman Jerome Powell's testimony to Congress, two-year yields surged above 5 percent. When the news broke about Silicon Valley Bank (SVB), they came tumbling back down, leading to their steepest two-day decline since the Black Monday market crash of 1987. The global banking turmoil has shifted expectations for the timing of a federal funds rate cut (see chart 1).

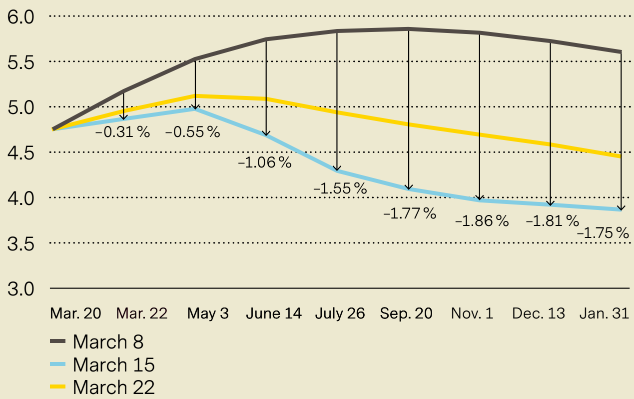
Our overall outlook for fixed income remains positive. We prefer the higher-quality end of the fixed income market, such as investment grade corporates, and see opportunities in emerging-market bonds. We maintain a defensive stance towards riskier credit with an under-weight in high-yield bonds.

The bond market sees a recession
In the wake of Powell's testimony, two-year yields shot up above 5 percent, causing the yield curve to become severely inverted. The yield on two-year notes was over 1 percent higher than that of 10-year notes, leading to the most inverted yield curve since the 1980s. The higher the Fed takes interest rates, the greater the chances of a deeper economic downturn. Eventually, this will result in even sharper interest rate cuts and lower bond yields. The yield curve is a leading indicator of what is currently happening in the economy, in contrast to economic data, which is lagging and subject to big revisions. While using the yield curve as a market timing tool is unwise, it would be equally ill-advised to disregard the message it is sending. The yield curve between two-year and 10-year notes has remained deeply inverted at around minus 60 basis points, a level that indicates a looming recession.

Credit fundamentals, while still strong, are on a negative trajectory
Credit fundamentals are starting to weaken slightly. Profit margins are declining across most sectors and interest expenses have started to rise, reflecting the backdrop of higher rates. Even so, leverage is flat for now as debt growth remains prudent. We remain comfortable with the fundamental backdrop overall, although the direction of travel is negative.

From a valuation perspective, high-yield bonds do not have a broad cushion against renewed spread widening and are first in line to see deteriorating credit funda-mentals in a weakening economic environment (see chart 2).

Chart 1: Expected Fed funds' path amid hawkish Fed speech and risk-off sentiment
Implied Fed pricing, in %



Source: Bloomberg, Vontobel

Chart 2: High-yield breakeven spread indicates a smaller buffer to withstand a wave of spread widening
In Bps

Source: Bloomberg, Vontobel

Financial stability vs. price stability: The Fed's balancing act

—
Markus Bruhin
Head Discretionary Mandates
Vontobel SFA

Equity markets have rebounded strongly since late September 2022. Hopes for an earlier Fed pivot spurred a strong January rally, which ran into skepticism in February as stickier-than-expected inflation raised the prospects of elevated rates for a longer period than anticipated. Something then "broke" in March with the fallout from the collapse of Silicon Valley Bank (SVB) and the subsequent stress across the banking sector took most by surprise.

The recent turmoil in the banking sector has raised concerns about the balancing act that central banks must now perform, as they weigh financial and price stability. The situation has been exacerbated by still sharply inverted yield curves, resulting in increased volatility. The turmoil sparked by the SVB fallout could complicate central banks' decisions, as it may encourage a slowdown in rate hikes, even as stubbornly high inflation calls for continued hikes. The Fed's last meeting signaled that it would prioritize and remain unconditionally committed to keeping inflation low, providing an answer to anyone wondering which camp will win.

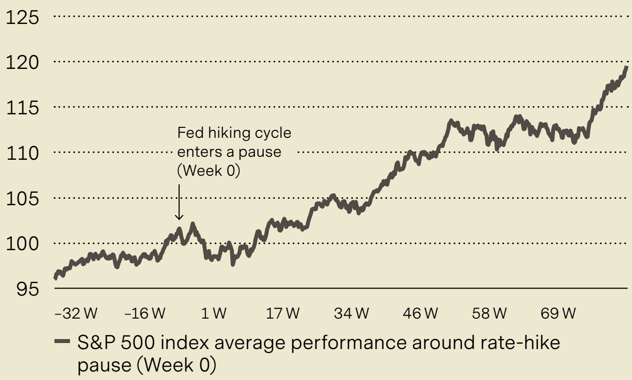
Recent events imply that banks will eventually need to recalibrate their lending strategies by de-risking them, as the impact of higher rates becomes increasingly visible. This is likely to affect businesses and consumers. Medium-sized US banks play a crucial role in the economy, accounting for 60 – 80 percent of residential and commercial real estate lending, and approximately 50 percent of consumer lending.

The current banking crisis could become a deflationary factor. However, even though there is no sign of a systemic risk for banks, further collateral damage from one of the most aggressive hiking cycles in the past 40 years cannot be excluded. A bigger crisis hitting other sectors cannot be excluded either, as this is the likely outcome of a policy-induced recession.

There have been thirteen distinct interest rate hiking cycles since 1974. On average, fed funds rates were hiked by 275 bps in each period and these periods lasted approximately 16 months. Equity returns (chart 2) have been positive on average after the Fed ends its rate hikes. The market loathes uncertainty and performs well after a Fed hiking cycle ends. However, without powerful catalysts such as looser monetary policy, equity returns will probably remain muted in the near term. The same applies to a possible Fed pause in the case of an inverted curve, as in the current situation. Although this does not mean we are back to 2008, we need to remain vigilant.

Chart 1: S&P 500 index performance around rate-hike pause since 1960

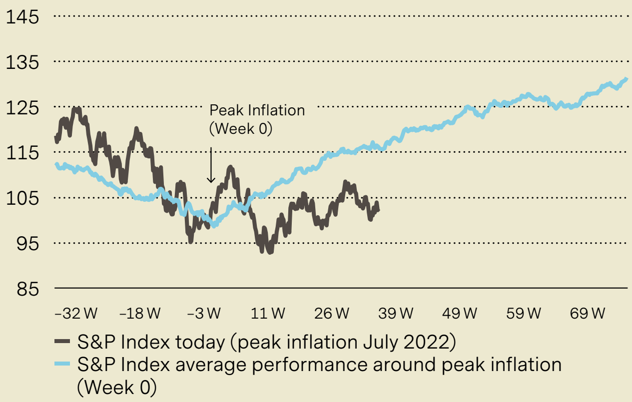
Average S&P 500 indexed performance at Fed pause for rate hikes



Source: Refinitiv Datastream, Vontobel

Chart 2: S&P 500 average peformance around peak inflation periods since 1950

S&P 500 indexed performance at peak inflation



Source: Refinitiv Datastream, Vontobel

Food prices should weaken after an unforgettable 2022

—
Christoph Windlin
Deputy Head
Investment Management,
Vontobel SFA

It's not that easy to predict the evolution of food prices, as they are influenced by numerous factors. One important driver is energy prices. High oil prices, for example, not only translate into higher fuel and fertilizer prices but also lead to a shift in food production to biofuels.

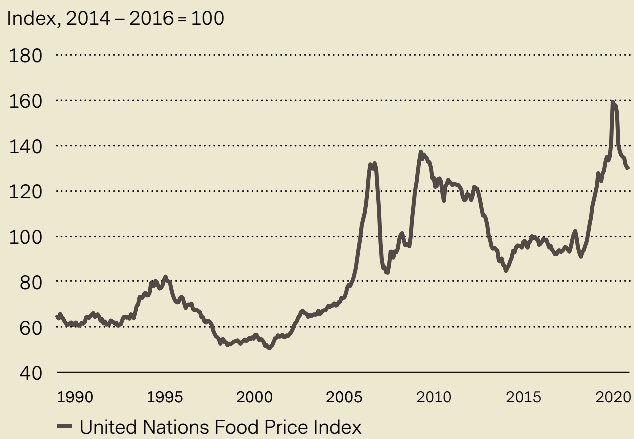
A further driver is US monetary policy. The International Monetary Fund estimates that a one percentage point increase in the fed funds rate reduces food commodity prices by 13 percent after one quarter. A third factor is the weather. Droughts or floods can lead to crop failures and reduce supply. In addition, other supply shocks, technological advances and changing dietary habits also play a role.

The situation had already been tense in the years leading up to it. Various grain-producing countries imposed export restrictions in 2020 for fear of food shortages, consumers and businesses began stockpiling supplies and the weather phenomenon put a strain on farmers for a third consecutive year. War then broke out between Russia and Ukraine—two major wheat producers—and with it, energy costs rose rapidly, driving global food prices to an all-time high (see chart 1).

Why we expect lower food prices in 2023
Food prices have come down from their highs but remain elevated by historical standards. There are several reasons why they should continue to weaken: interest rate hikes by the Fed, a significant decline in energy prices (see chart 2) and significantly lower fertilizer prices. Prices for the eight major fertilizers fell in February month-on-month, with five posting declines of 5 percent or more, according to DTN / Progressive Farmer.

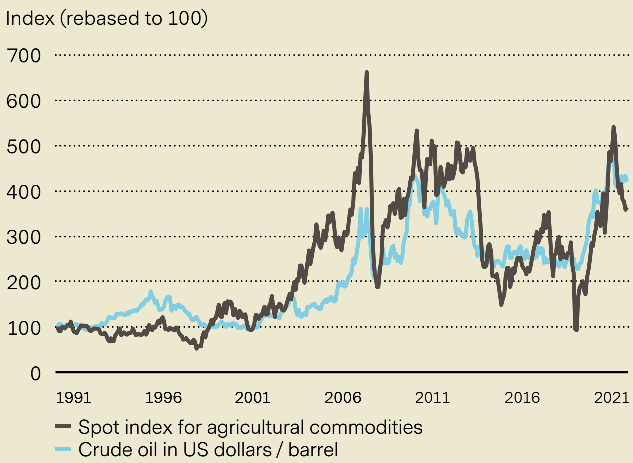
Gold as a portfolio diversifier and unattractive broad commodities
Gold has proven to be an efficient portfolio hedge against uncertainty about the future path of the economy and therefore future central bank rates. It is negatively correlated with real yields. As inflation is expected to decline further, nominal rates are projected to fall and real rates should decline. As global economic momentum is not expected to gain traction and demand for overall commodities should remain limited, we maintain an underweight allocation to broad commodities. The strong appetite of the Chinese economy at the early stage of its reopening process might argue against the underweight position in broad commodities. But supply chain distortions have already abated fully to pre-crisis levels, so that additional demand for commodities should also have normalized and the pick-up in demand from higher manufacturing activity in China should be absorbed by current prices.

Chart 1: Food prices have weakened but remain high



Source: Food and Agriculture Organization of the United Nations, Vontobel

Chart 2: Lower oil prices point to lower food prices



Source: Refinitiv Datastream, Vontobel

Impending end to the Fed's rate tightening cycle may weigh on the US dollar

—
Dr. Pascal Köppel
Chief Investment Officer,
Vontobel SFA

The dominant and most important topic on the market was the concerns about systemic vulnerabilities in the banking industry, triggered by SVB's demise, which resulted in falling yields and rising volatility. While this led most major central banks to revise the outlook for interest rates downwards, the European Central Bank persisted in hiking policy rates by 50 basis points at its March meeting. Recent events have highlighted the increasing trade-offs central banks must make between the need for restrictive policies to contain inflation and the danger of breaking something of systemic importance.

The medium-term performance of the US dollar will be influenced by monetary policy decisions, and we continue to believe that the impending end of the Fed's rate tightening cycle will likely reduce the dollar's attractiveness (see chart 1). Clearer indications of US inflation slowing will increase the currency's headwinds as markets grow more optimistic about the possibility of the Fed changing its course. A weaker backdrop for risk appetite, however, could support the US dollar in the short run, via the safe-haven channel.

The euro is set to strengthen
The dramatic repricing of the Fed cycle significantly lowered the two-year EUR/USD swap differentials (see chart 2). Exchange rates are typically strongly influenced by rates at the short end of the curve (indicating the path of respective monetary policy), and the sharply narrower spread would be expected to drive the euro much higher. Markets are now betting on the Fed making a U-turn, but they are also factoring in a greater degree of contagion from the turmoil in the banking sector, which is ultimately impacting risk sentiment and preventing EUR/USD from breaking higher for now.

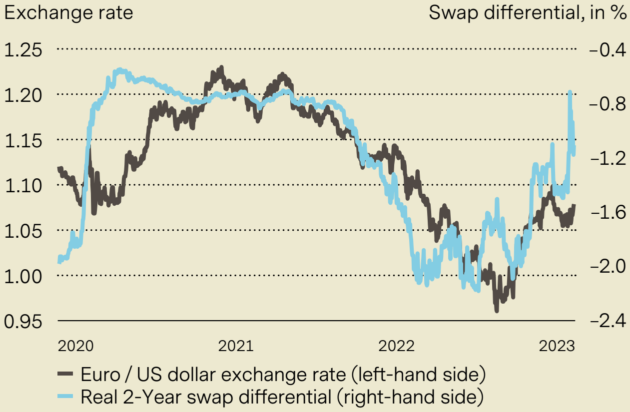
ECB President Christine Lagarde has also provided more details on the key data points the central bank will consider when setting interest rates. These include inflation forecasts, economic and financial data, as well as the dynamics of underlying inflation, with an emphasis on wages. The ECB is also keeping an eye on the strength of monetary policy transmission. We see strong evidence that higher risk-free rates are swiftly passing through to borrowing costs faced by households and businesses. Credit demand and supply is also falling quickly.

Monetary policy will likely continue to be just as impactful in the euro zone as it has been in the past. As such, the ECB is poised to raise rates further as we head into the summer months, if financial stability is to be preserved.

Chart 1: The dollar retreats

Source: Bloomberg, Vontobel

Chart 2: Re-pricing of the Fed cycle has caused 2-year EUR / USD swap differentials to narrow



Source: Bloomberg, DB, 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	2.3	2.2	2.6
Eurozone	5.3	3.5	1.9	0.5	1.2
USA	5.9	2.1	0.9	0.9	1.2
Japan	2.3	1.1	0.4	1.1	1.1
UK	8.5	4.0	0.4	–0.5	0.9
Switzerland	4.3	2.0	0.8	0.6	1.4
Australia	5.3	3.6	2.7	1.7	1.6
China	8.4	3.0	2.9	5.3	5.0

INFLATION	2021	2022	CURRENT[2]	2023 CONSENSUS	2024 CONSENSUS
Global (G20)	3.5	7.3	6.6	5.2	3.5
Eurozone	2.6	8.4	8.5	5.7	2.4
USA	4.7	8.0	6.0	4.1	2.5
Japan	–0.3	2.5	3.3	2.2	1.2
UK	2.6	9.1	10.4	6.5	2.4
Switzerland	0.6	2.9	3.4	2.4	1.4
Australia	2.9	6.6	7.8	5.5	3.1
China	0.9	2.0	1.0	2.3	2.3

KEY INTEREST RATES (IN %)	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR	–0.50	2.00	3.00	3.57	3.51
USD	0.25	4.50	5.00	5.35	4.90
JPY	–0.10	–0.10	–0.10	–0.10	–0.08
GBP	0.25	3.50	4.25	4.35	4.05
CHF	–0.75	1.00	1.50	1.69	1.63
AUD	0.10	3.10	3.60	4.00	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 IN 12 MONTHS
EUR (Germany)	–0.2	2.6	2.20	2.66	2.26
USD	1.5	3.9	3.44	3.66	3.38
JPY	0.1	0.4	0.32	0.64	0.68
GBP	1.0	3.7	3.38	3.49	3.11
CHF	–0.1	1.6	1.14	1.59	1.41
AUD	1.7	4.1	3.19	3.81	3.40

FOREIGN EXCHANGE RATES	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS END OF 2024
CHF per EUR	1.04	0.99	0.99	1.01	1.02
CHF per USD	0.91	0.94	0.92	0.92	0.91
CHF per 100 JPY	0.79	0.72	0.70	0.72	0.73
CHF per GBP	1.23	1.12	1.12	1.13	1.14
USD per EUR	1.14	1.06	1.08	1.10	1.12
JPY per USD	115	130	131	127	125.50
USD per AUD	0.73	0.67	0.66	0.71	0.72
GBP per EUR	0.84	0.88	0.88	0.89	0.90
CNY per USD	6.37	6.91	6.88	6.70	6.70

COMMODITIES	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
Brent crude oil, USD per barrel	79	86	75	86.75	95
Gold, USD per troy ounce	1,829	1,824	1,959	1,875	1,875
Copper, USD per metric ton	9,720	8,372	8,922	8,500	9,350

[1] Latest available quarter
[2] Latest available month, G20 data only quarterly
Source: Vontobel, respective statistical offices and central banks; as of March 25, 2023

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