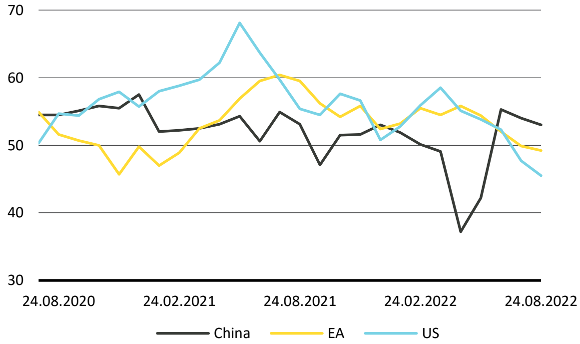
Investment Focus

Severe economic downturn ahead?

Inflation continues to rise due to the Russian-Ukraine war and the COVID-19 lockdowns in China. The markets expect central banks to tighten ever faster – and the banks agree. Bond yields are rising, which is bad for markets. The loss of real purchasing power is lowering growth expectations. Economic growth is already flagging. Are we facing mid-cycle weakness or a serious slowdown in economic activity in the developed countries? And could this impact the worldwide economy too? Markets increasingly expect a serious slowdown and believe a recession is much more likely than current economic data suggests. The very recent PMI numbers at the end of August for the US and the euro area (EA) fell below the important 50 level. Economic activity is expected to slow down even more in the coming months.

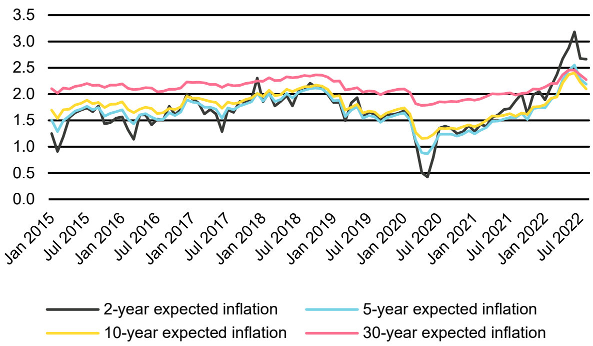
Purchasing manager indices (PMI Composite) – Deceleration ahead?



Source: Bloomberg, Vontobel SFA, as of August 2022

What happens next depends largely on the robustness of consumers and the persistence of inflation. These are likely to determine the future stance of monetary policy in the advanced economies, especially in the US. An end to China's COVID-19 related lockdowns would also lead to fewer economic and probably inflation concerns – even if China's opening may trigger a surge in demand for commodities. Fewer supply bottlenecks would also help to alleviate inflation worries and support the economic development of the industry-heavy EA. The future mix of growth and inflation, however, is difficult to assess. The US Federal Reserve Board (Fed) seems to have convinced markets that it will fight inflation even if it means a significant drag on growth. Recession fears have therefore taken over the baton from inflation fears. Nevertheless, it is still unclear what this implies for the future path of US central bank rates and US economic growth. Is a severe downturn of US economic activity and thus of the global economy needed to tame inflation and keep inflation expectations anchored? Or could the hiking cycle end at rates that keep financial conditions favorable for companies and investors? This uncertainty about the future stance of US monetary policy has been the culprit for the poor performance of both equity and bond markets. This can be seen in the clear outperformance of defensive over cyclical equities and in the fact that medium- and long-term inflation expectations in the US have already been falling again since the end of April. Markets are already betting on a more pronounced economic slowdown and are pricing in more than just a shallow recession.

US inflation expectations (in %)



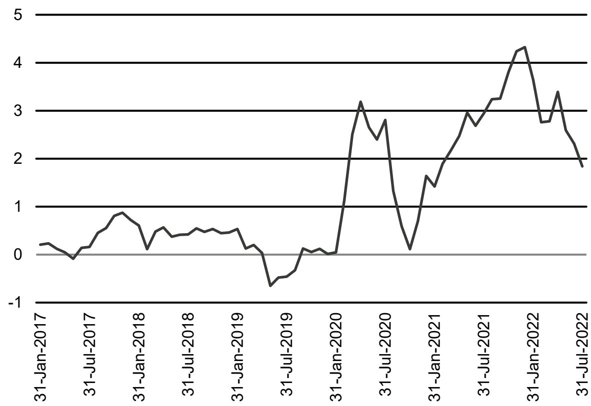
Source: Federal Reserve Bank St. Louis, Vontobel SFA

The same reasoning also applies for monetary policy prospects in the EA. The European Central Bank (ECB) started to lift its key policy rates out of negative territory at the July meeting. Investors apparently anticipate a pronounced adjustment pace to the ECB's terminal policy rate. This expectation about the future stance of monetary policy in the EA combined with the sharp drop in business sentiment indicators, such as the PMI or the business sentiment released by the European Commission, have created severe concerns about the future strength of the EA economy during the second half of 2022 and into 2023. While the Fed has stepped up the rhetoric recently to unambiguously clarify their intention to bring inflation back to the policy objective, the ECB stressed again the fact that policy normalization will also mean taking into consideration the future cyclical environment and the respective implications for economic growth and unemployment.

Some glimmer of hope from the supply side

With further progress on the supply side, central banks in the advanced economies, especially in the US and the EA, should gain some leeway to moderate the rate-hiking cycle. Indeed, there is some optimism on the horizon that supply chain disruptions have started to gradually abate over the summer months. If this evidence materializes as sustainable, supply-side created inflation should start to fade.

Global supply chain pressure – Gradual abating

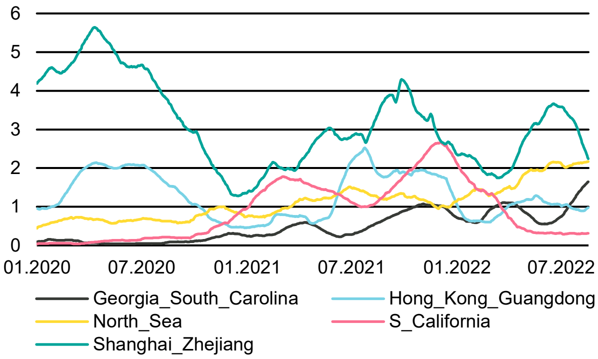


Source: Federal Reserve Bank New York, Vontobel SFA

The Global Supply Chain Pressure index, established and released by the Federal Reserve Bank of New York, reveals that global supply chain disruptions have halved. The index dropped over the summer months from its peak of 4 index points in June to 2 index points in August. According to the Vistage US CEO confidence survey of the second quarter of this year, approximately 43% of corporate leaders reported that supply chain disruptions were getting better; an increase of around 10 percentage points compared to the results for the first quarter 2022. This combination of hard and soft data relating to supply chain disruptions shows that bottlenecks are slowly declining. This evidence is also observed in Europe. The IFO Institute of Economic Research in Munich released a report at the end of August showing that supply chain disruptions are also gradually easing across almost all sectors in the German economy, ranging from a high of 85% in the engineering sector to a low of 19% in metal processing. The average value for the overall German manufacturing sector stands at 62%. This is a drop of more than 11 percentage points relative to the value published in July.

According to the World Trade Monitor of the Institute of World Economics in Kiel, Germany, data on shipment and freight costs also indicate that some relief has been achieved and that further progress can be expected. Port shipment completions in major ports in North America and Asia have continued to rise throughout the summer months. Freight on stationary ships as a fraction of total goods shipped at sea has already declined since mid-2021 and has now dropped below 12%, the lowest level since the end of 2020. The same observation applies to daily freight capacity in the Red Sea. Due to the geographical location of the Red Sea the shipping operations here reflect the trading activity between Europe and Asia.

Port traffic and ship completion (index points)



Source: Institute of World Economics, Kiel, Vontobel SFA

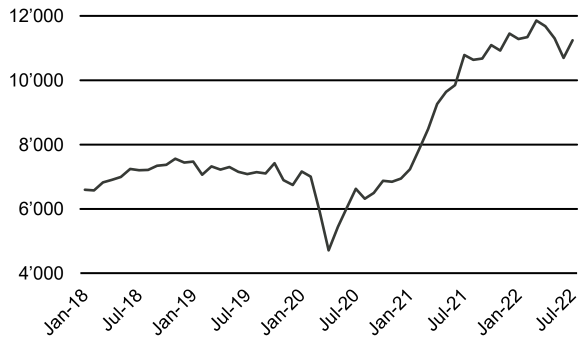
The development of world trade may also reveal further evidence about the state of the global supply side of the world economy. World trade continues to expand significantly above trend since autumn 2021, due to the re-opening of the global economy in the aftermath of the COVID-19 pandemic. With the outbreak of the Russian-Ukraine war, the sanctions on Russian imports and exports and the respective Russian retaliations, world trade activity declined back to the trend level. With the lifting of containment measures in China, however, world trade started to recover. In May, trade growth reached 2.5% month-over-month. This corresponds to an annualized growth rate of around 35%. In June, global trade remained unchanged at this high level, despite concerns about the future path of central bank rates and the prospects for the global economy. Exports (13.0%) and imports (7.0%) from China have started to rise sharply again, partly related to the end of the lockdown in Shanghai on June 1, which allowed the port to run at almost full capacity again.

All these little pieces of evidence show that the supply side of the global economy has started to recover after the COVID-19 pandemic and its impact on the global economy. Provided this recovery process continues, we are confident that a severe economic downturn can be avoided.

Where have all the workers gone and why?

The acceleration of inflation over the past two years has eroded the purchasing power of domestic demand globally, especially in the advanced economies. In addition, the current expected future path of interest rates and bond yields combined with concerns of a significant slowing of economic activity and a marked rise in unemployment in the economies of the Western hemisphere will be a further drag on global demand. Despite tighter financial conditions in the US, job openings remain at record highs. They currently stand at nearly 11 million, 7 million above the pre-crisis level, spurring many employees on to voluntarily resign from their current jobs and start searching for jobs offering more attractive conditions, financial and otherwise.

US job openings (in thousands)

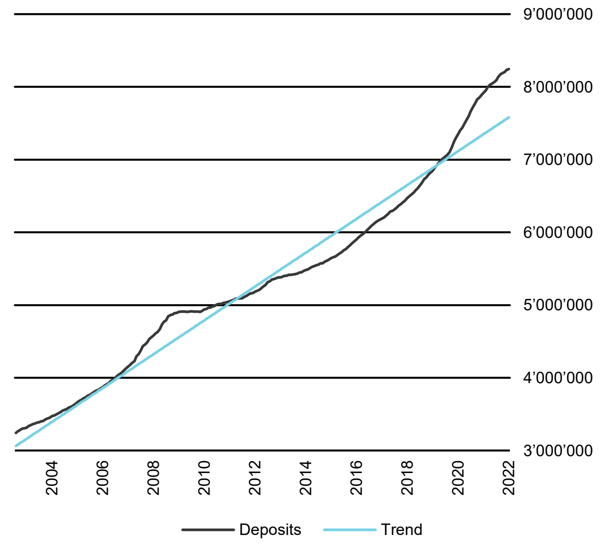


Source: US Bureau of Labor Statistics, Vontobel SFA

The quits rate has increased close to 3% per month; this means that approximately 4.5 million employees are resigning voluntarily per month. This puts pressure on wage growth and may risk initiating a recurring feedthrough from higher wage growth to accelerating inflation back to higher wage growth, especially if long-term inflation expectations are derailed. The Fed is therefore targeting this excess labor demand, especially in the service sector to crack this wage-inflation impetus.

Forced savings during the COVID-19 crisis are the subject of much debate. The US personal savings rate surged to over 30% in 2020, fell back and soared again to a level of around 20%. The savings rate is now back to around 7%. We have also observed a very similar pattern for the behavior of the EA savings rate, with the exception of private households' savings rates that continue to exceed the long-term average. Savings are derived from setting aside a certain portion of income over a specific period. Therefore, today's level of savings does not tell us much about the potential of pent-up demand in the US and the EA. As income is booked in the banking system and savings are residual income left over after consumption decisions, we must look at total deposits held by private households in the banking sector in the US and the EA to assess the potential of pent-up demand. Let us start with an analysis of total deposits in the EA.

EA pent-up demand – Deposits all commercial banks (in millions of Euro)

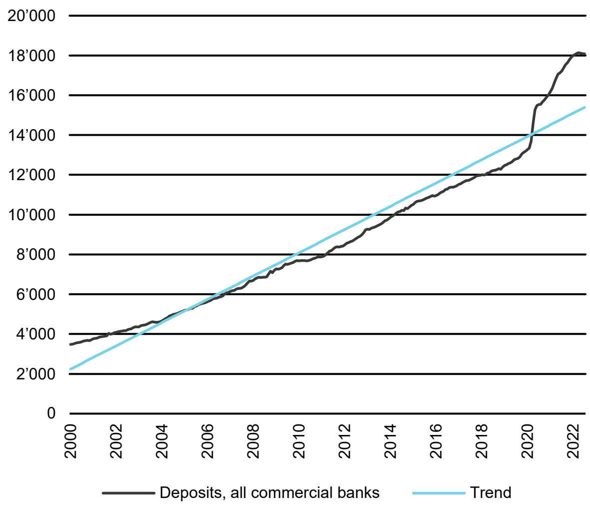


Source: European Central Bank, Vontobel SFA

Since March 2020, total deposits are expanding above trend. Above-trend total deposits nearly doubled from March to April 2020. Since then, EA private households have accumulated an additional EUR 13.635 trillion in total deposits. This corresponds to approximately three times the nominal GDP of Germany and amounts to around three quarters of European Union nominal GDP.

A very similar pattern can also be observed for the US. Total deposits are moving above trend since April 2020, as the COVID-19 pandemic reached the US a little later than Europe. Since then, the private household sector in the US has generated USD 2 trillion above-trend deposits, resulting in an accumulated amount of USD 60 trillion. This is approximately three times US nominal GDP.

US pent-up demand – Total household deposits, all commercial banks (in billion USD)



Source: Federal Reserve Bank St. Louis, Vontobel SFA

Although consumer sentiment in the US and the EA has plummeted significantly over the past months as inflation concerns have accelerated, private household expenditure is still growing fast. Personal consumption expenditure in the US is running at a pace of around 10% and individual private consumption in the EA is growing at a rate of about 13%, according to the ECB. This is a remarkable development. Of course, the prices of many important goods have risen substantially in recent months and many households in the US and the EA have not yet adjusted their consumption behavior to their incomes' lower level of purchasing power. This supports economic activity in the US and the EA, which is a positive development. If however, this potential demand is available for private households as a cushion against higher inflation and potential job losses to maintain current living standards, it is even more difficult for monetary policy to restore price stability. Indeed, this phenomenon of excess funding available may also explain why the participation rate in the US labor market has not yet returned to pre-crisis levels, especially in the age class between 16 to 25 years. The participation rate in this cohort is still five percentage points below the pre-crisis level.

Foreign exchange: the NOK, the SEK and the USD: what else?

We have two preferred currencies where we engage in directional investment: the Norwegian Krona (NOK) and the Swedish Krona (SEK). We expect further appreciation potential for both currencies, based on tighter than expected monetary policy in both countries.

The Swedish central bank declared that it will return to price stability as soon as possible. Nevertheless, this undertaking is not easy to achieve. Economic activity in the manufacturing sector is strong, business sentiment in this sector is good and resource utilization is robust. The central bank acknowledges that a "soft landing" is difficult to achieve as the natural rate of interest that equates demand and supply to create price stability is unknown. The Swedish central bank also emphasized several times, that by raising the policy now and fast, the risk of high inflation in the long-term is reduced and thus also the need for greater monetary policy tightening. Hence, the Swedish central bank raised rates by 0.5 percentage points instead of by a quarter point in June, to 0.75%. Indeed, we believe that the Swedish central bank has strong arguments in favor of raising rates by even greater increments, as current inflation at nearly 7% is running approximately two percentage points above their current projections. As uncertainty about inflation with respect to the speed of deceleration remains elevated, we expect the Swedish central bank to hike rates quickly to close to 2% by the end of this year, which should be supportive for the SEK vis-à-vis the EUR and potentially the Swiss franc.

The state of the economy in Norway is very similar to that in Sweden. Current inflation at approximately 2.5 percentage points is well ahead of the central bank's projections and five percentage points above the policy objective of 2%. Unemployment has fallen close to 2% and the economy is operating at full capacity, as employment as a share of the working age population has climbed to the highest level for a decade. The Norwegian central bank has raised rates six times this year to 2.25%. For this reason, the NOK continued to appreciate against the EUR and has been able to limit the depreciation against the Swiss franc and the USD. We believe the NOK appreciation will gain even more traction as Norges Bank is expected to continue to tighten monetary policy as a result to close the gap between inflation and the policy target as quickly as possible. For these reasons, we re-iterate our overweight allocation to the NOK and SEK respectively.

Investors have been increasingly debating the long-term fate of the EUR. On the one hand, the ECB is normalizing policy at a rapid pace, easy fiscal policies and public investment remain a key growth tailwind, and investors have been under-allocated to European investments for much of the past decade. On the other hand, an economic slowdown in the EA, depending on the magnitude of the energy shortage during the heating season, elevated geopolitical uncertainties and finally, lagging fixed income returns in Europe compared to other countries, are drags on the EUR.

We expect the short-term pain to continue, with EUR/USD having breached parity. This is because it looks increasingly unlikely that we will see the two necessary conditions for USD weakness taking place simultaneously (global growth expectations bottoming out and inflation and Fed expectations peaking) anytime soon.

We are skeptical that the ECB’s recent hawkish pivot will be sufficient to stabilize the EUR versus the USD, given that local stagflationary concerns continue to strengthen and external forces continue to point to a stronger USD. In the longer term, however, particularly in 2023 and beyond, we think ECB normalization and higher European yields could have unexpectedly EUR-positive effects, which are underappreciated by a EUR-bearish market. A reversal in longstanding capital outflows as local yields rise could prove a meaningful EUR tailwind.

Can the EA economy and the EUR handle ECB normalization? While the short-term outlook for EUR/USD looks challenging, we should not ignore important long-term themes. We think investors are underestimating the probability that Europe can handle normalization and the impact that higher local yields may have on the EUR at a later stage. The prospect of ECB normalization has driven EA Government bonds (EGB) yields higher, with spreads on peripheral yields widening to near 2018 levels and the nominal level of peripheral yields (as proxied by Italy) rising to roughly 10-year highs. We think investor concerns about fragmentation, disproportionate tightening of financial conditions in the periphery states and an inability of the eurozone economy to handle ECB normalization are overblown. Therefore, from a longer-term perspective, we remain positive for the European economy and its common currency.

Global fixed income: stay with hard and local currency emerging market debt

Since the beginning of the year global fixed income markets have experienced rising yields and spread widening, caused by accelerating inflation and expectations of monetary policy normalization. In the wake of this uptrend of yields, fixed income investment, both government and non-government debt, posted negative returns in tandem the negative performance of global equities. The usual negative correlation between equities and bonds which can be used to diversify multi-asset portfolios reversed into a positive correlation by the co-existence of soaring inflation and the projections of fast rising central bank rates to tame inflation. As textbook economics tells us, the level of nominal long-term rates is defined as the sum of expected short-term rates plus estimated inflation over the maturity of the bond investment. This relationship explains the sharp increase of bond yields since the start of 2022. Since the beginning of 2020, 10-year US government bonds yields rose from approximately 1.5% to around 3.7%. In the EA, the respective 10-year yield by two percentage points to 2% in Germany and by around 2.9 percentage points to 4.4% in Italy. Inflation and the expectation that monetary policy is starting to normalize has ended the eight-year period of negative interest rates in the EA. At the same time, global equity markets have also suffered losses. As future interest rates are projected to rise, the present value of earnings declines and hence investors start to sell equities. This makes-up the positive correlation between bond and equity markets performance that was observed very recently.

Within the fixed income space we continue to prefer hard and local currency-denominated emerging market debt. Hard currency-denominated emerging market debt should continue to benefit from a firm USD at least over the coming months. With the depreciation of emerging market currencies of around 15% since mid-2021 versus the USD, valuations of local currency-denominated debt have gained attractiveness and also show risk-adjusted attractive yield pick-ups. For these reasons, we continue to overweight this sub-asset class.

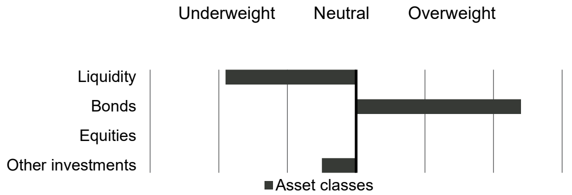
With respect to yield curve positioning we favor intermediate maturities in all our reference currencies, which keep the portfolio duration close to the market duration. As the yield curves in the EA and Switzerland are upward sloping, we benefit from the positive roll-down return as the bonds continue to mature. Our recommended duration strategy to stay close to the market duration will limit potential losses, should the yield curve shift upwards. In case yields shift down, if economic and / or inflation starts to decelerate, our curve positioning could deliver attractive risk-adjusted capital gains.

Global equities: do not sell and go away!

After the fierce speech of Fed chair Powell in Jackson Hole and more inflation-prone plea of some members of the Executive Board of the ECB in the recent weeks, we have decided to reduce cyclical risks in our portfolios. We are actively reducing our equity exposure to the strategic weight by selling our global and international diversified equity instruments and switching the proceeds into cash in the respective reference currencies. This enables us to re-enter the equity markets quickly as soon as conditions become more favorable again. Nevertheless, our portfolios continue to be exposed to cyclical risk. In a balanced mandate, the equity exposure stands at 50% and shows an allocation of 6% to emerging market bonds. A further reason for our decision to bring our equity exposure close to the strategic weight is that volatility could rise again after the fall since the beginning of the year. The impact of the Fed’s “quantitative tightening” on risk asset markets was the subject of much discussion. The

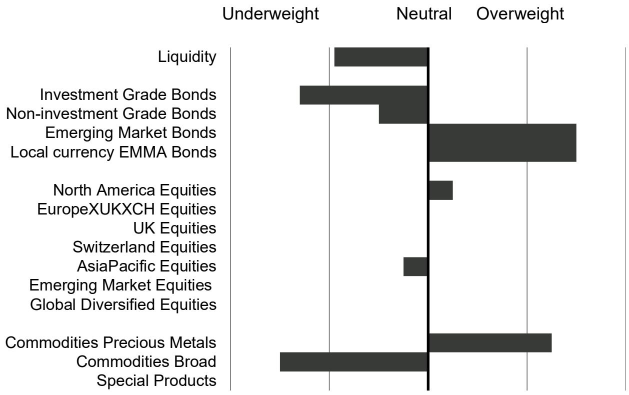
Fed, however, has reduced its balance sheet by approximately 1.5% up to now and the current balance sheet is still 3.5 times larger than at the start of "quantitative easing" in 2012. When the Fed seriously begins to withdraw liquidity from the market and will no longer be on autopilot but determine monetary policy instead depending on data, this may cause volatility to rise again. In addition, the mid-term elections in the US are still on the agenda in November which has historically also caused increased uncertainty on the markets. The correlation between the monthly change in volatility and changes in equity market performance stands at -0.8. This implies that a ten percent increase in volatility causes equities to drop by around 8 percent. In view of all the uncertainty, we continue to be very broadly positioned in terms of equity regions.

Asset class preferences



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

Sub-asset class preferences



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

The US equity market is most exposed to tighter financial conditions and hence to a stronger softening of economic activity. At the same time, the US equity market has proven to be more resilient during times of cyclical downturns. As the experience from the 1970s and 1980s demonstrates, equities react harshly to fast-rising central bank rates and tightened monetary policy conditions. As it is still open whether the US central bank is only targeting a reduction in the number of job openings without substantially increasing unemployment, we maintain a neutral positioning, although some metrics have significantly improved for US equities. For instance, looking at cyclically adjusted price-to-earnings ratios (CAPE), which has fallen in the US from 22.3 to around 18 since the beginning of this year, the US market is no longer priced expensively historically. In this context, EA equities are even more attractively priced at the index level. They are already implying a substantial slowing of the EA economy, but not yet a severe economic slowdown. The EA equity market offers interesting valuations but is more exposed to global cyclical risks, especially as the slowdown may also include the Asian economies given tight trade relationships of the European economies with Asia, especially China. We keep, however, a neutral allocation to EA equities. The UK is exposed to inflationary risks and the Bank of England is expected to pursue a rigorous anti-inflation policy. Hence, a neutral allocation to UK equities is warranted.

All in all, we think it would be wrong to completely subscribe to the widespread pessimism and miss out on a possible market recovery. Even if the situation remains opaque and volatile in the short and medium term, and it may still take a final capitulation by investors to approach or surpass the old lows, we remain constructive for the long term. We therefore have a balanced position, with equities at the strategic allocation weight, with broad and global diversification.

Disruption in the European energy market – production cuts are unlikely

The negative news about Russia's energy supplies to Europe continues, as the latest Nord Stream 1 outage sent wholesale natural gas prices soaring again, offsetting some of the recent corrections. Consumer energy price inflation, capturing both natural gas and electricity, is extremely elevated too and may rise further in the euro area (EA) and the United Kingdom (UK). After nuclear power, which contributes more than 25% to the energy market in Europe, according to data from the Fraunhofer Institute of Solar Energy, gas is the second most important energy source for the European economy, with a contribution of 17%. Gas suppliers are also viewed as "marginal suppliers", which can increase (or decrease) prices when demand for their product increases / decreases. Therefore, current elevated gas prices have also driven up power prices sharply. Although measures have been introduced to reduce the demand and consumption of gas and gas storage have already reached the 80% of total storage capacity generally only seen in October, concerns are rising that gas rationing must be applied during the heating season if further gas imports become impossible. This may have severe implications not only for heating in private houses but also for economic growth and employment.

Despite these large shocks to gas prices and consumption, most indicators suggest that industrial production cuts appear somewhat limited so far. Headline industrial production (IP) has trended up in both the euro area and the UK through June and July. The gas-intensive composite IP has declined only modestly in both the euro area and the UK throughout the summer.

European equity analysts also see only modest to moderate production cuts so far among the companies they cover, largely concentrated in metals and especially chemicals, while reporting no substantial cuts in the paper, building materials, food and capital goods industries. Extending the scope to all European chemicals, there have already been significant production cuts, particularly for energy-intensive ammonia and ammonia derivatives used in fertilizer production.

Gas-industry related PMI and IFO numbers paint a mixed picture for the outlook for the European industrial sector. July IP data from Germany shows a fall of nearly 2% in gas-intensive IP month-on-month. Industry surveys point to additional deterioration in August. Specifically, the output component of our European gas-intensive composite PMI declined further to 40.7, a level only surpassed during the great financial crisis (GFC) and the initial COVID-19 lockdowns. More strikingly, the gas-intensive composite of the IFO survey showed only a minor dip in German business climate expectations.

So far, IP has proved resilient to rising gas prices based on the ability of companies to pass through higher prices in response to resilient demand. This is also due to a limited increase in energy costs for some companies so far (for instance because of hedging) and in the cost of shutting down factories. We expect abating inflation due to fading supply chain disruptions. This is expected to provide some relief for real consumer incomes and consumer demand, and thereby enable industrial companies to continue to partially pass-through higher costs and make production cuts less likely. In addition, fiscal and energy policies will play a major role in shaping industrial activity. Policies limiting the real income shock—such as the UK's proposal to freeze domestic energy bills at £ 2,500 per annum from October for two years—would likely also reduce the very substantial downside risks to activity.

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