Vontobel

US Investors' Outlook

Three bowls of porridge

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Three bowls of porridge

—
Dr. Pascal Köppel
Chief Investment Officer,
Vontobel SFA

Dear readers,

In the blink of an eye, circumstances have changed, stirring the pot even though investors' concerns remain unchanged: interest rates, inflation and the debate on will-there-won't-there be a recession are still on their minds. The US Federal Reserve's economists dropped their projections on the recession and many investors' expectations now lean towards a soft landing, with the possibility of elevated rates for longer.

The data set therefore is mixed; some data point to a recession while others indicate robust growth. The inverted yield curve, tighter bank lending standards, as well as some probability indicators, point to a higher risk of a recession within the next 12 month. Additionally, fiscal spending is extremely high and the budget deficit is around 8.5% of GDP. This has helped to keep the economy running but limits the fiscal scope to withstand economic headwinds.

On the other hand, the rate increases have not overly impacted consumers and corporates. The labor market shows some signs of cooling but remains tight. Job openings were elevated at 8.8 million in July but are down from the record 12 million in March 2022, and are therefore moving in the right direction. Overall US non-financial corporate net interest costs have not increased so far. A soft landing could represent the best-case scenario here, as it would generate enough demand destruction to get inflation under control, allowing central banks to pause and maybe even cut rates if necessary. It would also pave the way forward for calmer markets. The question therefore remains unanswered—will we have a soft landing, a hard landing, or no landing at all?

In order to translate the various scenarios into an analogy for investors, the current situation calls for finding just the right temperature, much like in the fairytale in which Goldilocks finally finds the third bowl of the three bears' porridge to her liking, being neither too hot nor too cold, but just right.

But what we can say is that with the slowdown in growth and the approaching end of the rate hike cycle, today's high bond yields provide investors with a good opportunity to lock in the current elevated rates for an extended period. In fixed income, we favor opportunities in the four to six-year duration segment in high quality government and corporate bonds. We are also shifting our regional equity allocation. We are reducing our exposure to UK equities, which performed strongly last year and are investing more in the Swiss equity market. We expect this market to be somewhat more defensive as well as offering high quality and less exposure to inflation.

China is responding with a broader package of measures to stimulate economic growth. The government recently cut the stamp duty on stock trading and adjusted rates several times. Two or more reserve rate cuts are expected and some easing on home purchase restrictions will follow as well. Overall, while China is not growing as expected, the government is responding with several steps on the monetary, fiscal and property front.

The Eurozone is expected to grow somewhere between 0.5% and 1% in 2024. Germany is the laggard and Spain is expected to report the highest growth (+2.2% in 2023) of the large Eurozone countries. Eurozone labor markets remain strong with record low unemployment and strong nominal wage growth. Inflation has peaked and is running at 5.3% y/y in August. As we see it, disinflation will continue.

Whether a recession happens or not, a diversified portfolio can help to avoid the effects of market volatility. At our most recent Investment Committee meeting, we confirmed our asset allocation. Read up on the dynamics in fixed income, oil and the currency market in this month's Investors' Outlook

We're happy to share our bowl of porridge with you and trying to make it just right.

—
Dr. Pascal Köppel
Chief Investment Officer,
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—
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Deputy Head
Investment Management,
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—
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Rising macro-economic uncertainty

Market participants who expected August to be a quiet month for financial markets were thrown a curve-ball this time around. A rollercoaster of headlines from the US highlighted the stark contrasts found in the world's largest economy: on the one hand, we saw a downgrade of its long-term debt rating amid expected fiscal deterioration and a growing government debt burden, as well as rating downgrades for several banks, amidst the challenges arising from the sharp increase in interest rates. On the other hand, data showed that the tight housing market fueled construction spending, the robust labor market created new jobs and strong consumption continued to promote spending.

The question is how long can this go on? Globally, we see economic weakness, primarily in China and in core Europe. The outlook for the US has become more uncertain. The labor market is still strong but we also see signs of cooling. Whether that means the US will enter a recession in the short-term is uncertain in our view. However, it is clear that global economic risks are rising.

Macro uncertainty remains elevated and there is the potential for central banks coming close to the peak while inflation normalizes. We also see attractive yield levels. From an investment strategy perspective. fixed income has become more attractive due to the carry (locking in the yield) it can offer investors. In addition, duration can also offer protection if things turn sour. Please refer to the market highlights on this.

In general, the current environment argues in favor of a risk-conscious allocation. This approach runs through the different asset classes in our current allocation stance. In short, we prefer quality and duration. Please see the following page for our specific allocations. Even though we think it is appropriate to keep equities at the strategic weight, we have introduced a tilt towards safety within regions. We have added an overweight in Swiss versus UK equities. On the one hand, Switzerland offers safety within equities, while the index is less concentrated and less expensive than the US, another market that can be a safe harbor within equities. On the other hand, the UK faces a greater risk of a harder landing, given the inflation overshoot and significant response by the Bank of England. The index also has significant exposure to emerging markets and commodities. In other words, we see higher cyclical risks for UK equities.

	UNDERWEIGHT significantly	UNDERWEIGHT slightly	NEUTRAL	OVERWEIGHT slightly	OVERWEIGHT significantly	
1 Liquidity		→				We continue to hold an underweight in cash, as the expected returns on bonds are attractive.
2 Bonds				→		We are sticking to our slightly positive view on fixed income and reiterate all sub-asset class views. We remain overweight investment grade (IG) credit, due to our belief that current spreads offer a fair value risk-adjusted expected return, provided the global economy can avoid a severe downturn. We remain underweight high-yield bonds. In our view, companies with weaker balance sheets and a higher dependence on external finance are more at risk. Lastly, we also remain positive on emerging market debt, supported by an expected softening USD because of a less hawkish US central bank rhetoric and the Fed pause communicated in June. We should see lower two- and ten-year rates in the quarters ahead, so that we recommend slightly extending duration in investment grade bonds.
3 Equities			→			Central banks continue to be a very important driver of financial markets. As the purchase manager indices still show expanding activity overall in the services sector, even though the manufacturing sector activity is contracting, the overall economic downturn is not as pronounced as expected. In the scenario of a delayed recession, we therefore believe that an allocation to equities close to the strategic weight is still appropriate. Due to the rising uncertainty surrounding the macroeconomic outlook, we are introducing a defensive tilt via an overweight in Swiss equities versus UK equities, while having no regional preference on US, Asia Pacific developed markets, Europe and emerging market equities. That said, we do acknowledge the valuation discount of Europe and emerging markets.
4 Commodities / Gold			→			Q2 performance for commodities improved with the help of energy, but with the global economic manufacturing component still not improving, demand will stay weak. We confirm our general underweight allocation to other commodities. The precious metal complex year-to-date performance remains impressive but softened in Q2. However, the longer-term case for gold remains unchanged and we are keeping an overweight allocation, as it has been a systemic portfolio diversifier during times of rising market stress.

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

Diversifying assets before the onset of macro turbulence

—
Dr. Pieter Jansen
Chief Investment Strategist,
Vontobel SFA

Inflation data released during August confirmed that global disinflation continues. With this in mind, we are still somewhat above central bank targets. US core inflation, which excludes the volatile components of food and energy prices, is running at 4.7%. Europe has found it more difficult to bring down inflation, with core inflation still running at 5.3%. In China, deflation risks are back in focus, with headline inflation at –0.3% and core inflation barely positive (+0.8%). China is troubled by both structural and cyclical headwinds. Its economic struggles have a negative effect on economic growth in countries with significant exposure to China, such as Germany. However, it also means that China is contributing to the Western disinflation trend via exporting deflation.

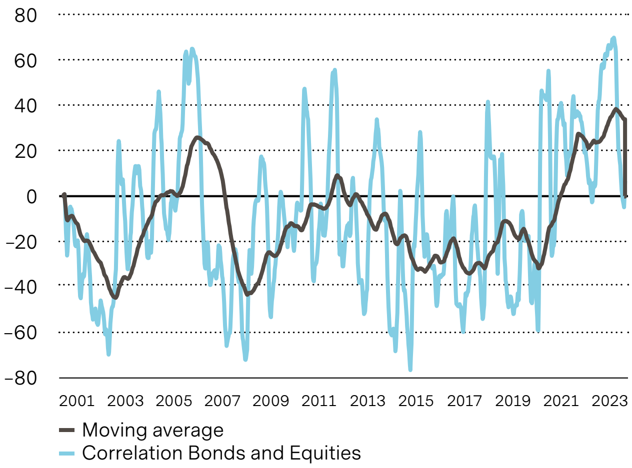
With cyclical economic weakness in Europe and Asia, the US is keeping the global economy afloat. With evidence of moderating inflation and after 525bp of rate hikes, the Fed has some leeway to see how the data develops. Jerome Powell made this clear in his Jackson Hole speech, where he indicated that the Fed can be careful and see how the data comes in. However, he was also conclusive that if the labor market does not cool down sufficiently, rate hikes will be back on the table again. We expect the Fed to pause for now and possibly hike again in November, if the data requires it to do so. The situation is much less relaxing for the ECB. Core inflation needs to come down much more, but economic momentum has already fallen sharply in the core countries.

The bottom line is that global economic risks are generally rising, but not enough in our view to make a recession imminent in the short-term. The market has priced in a soft landing. This means that "some rate cuts are priced in for next year and that expected corporate earnings growth has moderated somewhat. It is a benign scenario in terms of market pricing.

This creates two key risks in relation to market pricing. A first risk is that the economy enters a recession. The market reacts with lower price inflation, more central bank easing and a negative effect on expected corporate earnings. A subsequent flight to safety is plausible to follow (from risky assets into low-risk assets). A second risk is that inflation proves to be more sticky and central banks are forced to raise rates higher. While this might temporarily drive-up long maturity yields, it is equally likely that the market will see this as excessive monetary policy tightening that will make a hard landing unavoidable.
In this case, the curve could become much more inverted with a decline in corporate earnings expectations as well.

Chart 1: Positive correlation between bonds and equities is disappearing again

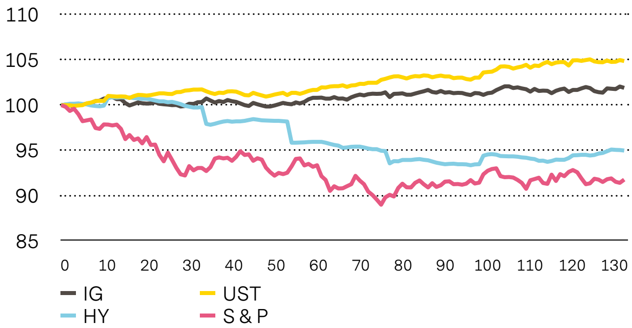
Correlation between bonds and equities in %



Source: Bloomberg, Vontobel

Chart 2: High quality and long duration fixed income tends to outperform during recessions

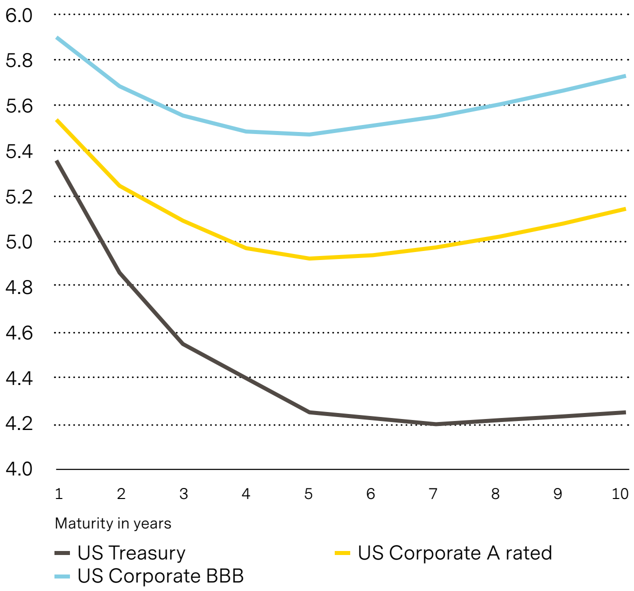
Total return index



Source: Bloomberg, Vontobel

Chart 3: Corporate bonds offer an interesting yield and curves are less inverted than government bonds

Yield in %



Source Bloomberg, Vontobel

Inflation rose quickly during 2022 and central banks were forced to catch up. There was no place to hide due to the positive correlation between equities and bonds: both were going down. This situation is returning to normal now and the positive correlation is disappearing (see chart 1). As is usually the case during recessions and periods of risk aversion, there is a likelihood of a negative correlation. The correlation between a 10-year US Treasury and the S&P 500 tends to turn negative during these shocks.

On the one hand, investors can currently lock in an interesting yield while fixed income can provide protection in case of unexpected cyclical headwinds on the other. This fixed income position can also include high-quality corporate bonds. Corporate bonds (A and BBB rated) with long durations tend to hold their ground during a recession (see chart 2). They do not benefit as much as government bonds during a broad market sell-off. However, they offer protection relative to short duration bonds, lower-quality corporate bonds (high yield) and equities, while providing an additional spread pickup over government bonds (see chart 3).

The tale of yields and maturity walls

—
Matthias Ribback
Portfolio Manager,
Vontobel SFA

Despite an attractive starting yield at the beginning of 2023, bonds have barely delivered a positive return year to date. The positive coupon income has been offset by a negative return due to rising yields. This effect is more pronounced for longer-dated bonds. We think yields are close to this cycle's highs, so that we are gradually increasing the duration of our portfolios.

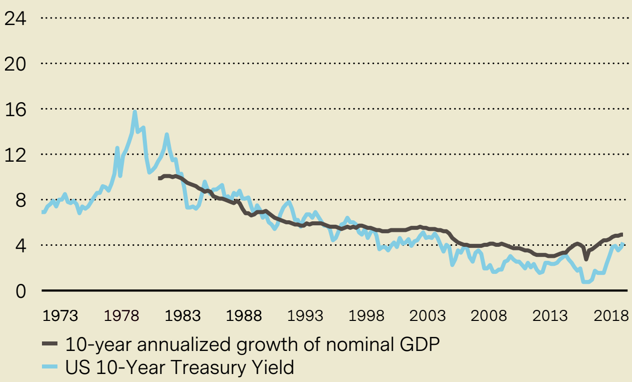
The most significant news currently in the fixed income markets is the 10-year Treasury yield reaching 4.3%. A level that has not been seen since November 2007. The 10-year annualized growth rate of nominal GDP could serve as a reference when examining the long-term trend in interest rates (see chart 1). The 10-year growth trend is on an upward trajectory and is now at its highest level since the Lehman crisis in 2008. For over 20 years, the 10-year yield has not ended a quarter above the 10-year nominal growth rate. A case could therefore be made that bond yields may not rise further in the present cycle.

Not all fixed income parts are created equal
We believe the absolute return potential across fixed income remains compelling, but favor higher-quality segments, such as investment grade corporates and treasuries. Despite the decline in credit spreads, we still think corporate bonds offer attractive risk-adjusted returns. An inflationary environment eases the debt burden and the Covid-19 crisis taught corporate treasurers to manage balance sheets in a defensive way. We do not expect a material rise in defaults in the investment grade area. Given our view that yields are close to peaking, we are gradually increasing the duration of our portfolios by buying longer-term bonds with maturities of up to 10 years.

Junk-rated companies on the other hand are in a race against time to replace the debt they secured when major central banks slashed rates and boosted quantitative easing programs to support economies two years ago. On average, these firms now have up to five years to secure fresh funding; the shortest timeframe ever. The amount of high-yield bonds maturing over the next two years has surged to a record high of USD 127 bn (see chart 2). This "maturity wall" accounts for 9% of the high-yield market.

When bonds have less than one year to maturity, this debt becomes current on a firm's balance sheet, which can potentially lead to downgrades. Considering that spread changes typically precede downgrades by one to two quarters, a negative spread reaction can start 18 months before the official bond maturity date. This looming maturity wall is poised to become a prominent concern for high-yield investors in the year ahead, especially given the rise in the cost of funding.

Chart 1: 10-year nominal GDP growth is a good indicator of bond-yield trend
In %



Source: Bloomberg, Vontobel

Chart 2: Maturity wall (of worry)—Bonds maturing in next two years has hit record (127 billion US dollars)
In %

Source: Bloomberg, BofA Global Research, ICE Data Indices, Vontobel

Changing the propellers

—
Markus Bruhin
Head Managed Solutions,
Vontobel SFA

Global stock markets traditionally never rise or fall in a straight line. The positive month of July saw the MSCI ACWI Index, the MSCI's flagship global equity index, firmly closing in on bull market territory. Investors who were eagerly awaiting arguments in favor of a correction during the traditionally unstable summer period were certainly not disappointed with August's mediocre performance.

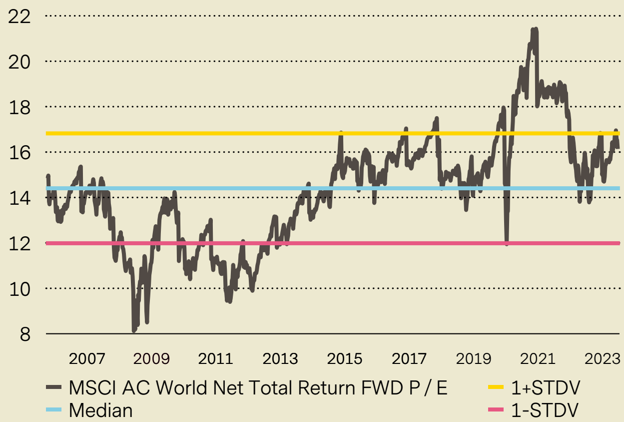
Stock markets faced steepening US yield curves, increasingly stretched valuations because of re-ratings (see chart 1), and uninspiring inflation data for July, all of which that pointed to a moderate uptick in most developed countries. This was followed by Fitch's downgrade of the US credit rating from AAA to AA+, along with soaring commodity prices and weakening economic data across most developed economies. Finally, instead of recovering, economic conditions worsened in China, the world's second-largest economy and biggest contributor to global gross domestic product growth.

To sum it up, it looks like a difficult task to find incrementally good news in the short term that supports stock markets. In fact, the solid earnings surprise during the Q2 reporting season was of little help to stock markets. They barely reacted, suggesting that most of the good news was priced in in the short term (see chart 2).

What is our take? Considering one of the most widely anticipated recessions in decades, we believe that investors with a long-term investment horizon should continue to take a constructive view on equities, even though it can be choppy in the short-term. Let us not forget that markets have also become increasingly efficient, structurally stronger and less leveraged in any historical comparison. Even so, we see volatility prevailing in the near term in the absence of catalysts. This has led Vontobel SFA's Investment Committee to remain tactically invested at the long-term strategic weight. We continue to seek opportunities in selected regions displaying quality and sound earnings predictability. For our global programs, we introduced a defensive tilt with an overweight in Switzerland versus UK equities. Ultimately, a flight to safety within equities would be beneficial for Swiss equities. Although US equities could also benefit from such flows, the valuation for Switzerland is more compelling than for the US. More details on page 5.

Chart 1: Forward P / E valuations have mostly expanded on re-rating since last year

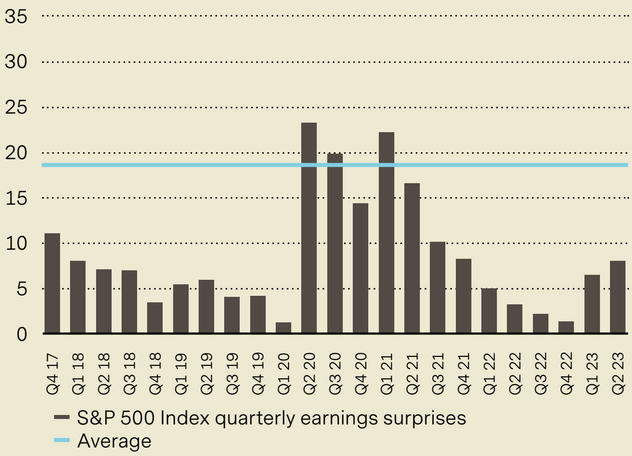
Forward P / E multiple



Source: LSEG, Vontobel

Chart 2: US equities—Q2 brought a clear inflection in positive earnings surprises

In %



Source: LSEG, Vontobel

Crude oil: tight supply has a tough fight against weak demand

—
Christoph Windlin
Deputy Head
Investment Management,
Vontobel SFA

This summer, crude oil prices seemed to climb in lockstep with the sweltering temperatures. Reductions in supply and low inventories support oil prices, but an uncertain economic outlook limits upward potential. These growing economic uncertainties and continued weakness in China continue to keep cyclical commodities, such as base metals, under pressure, while gold remains well supported.

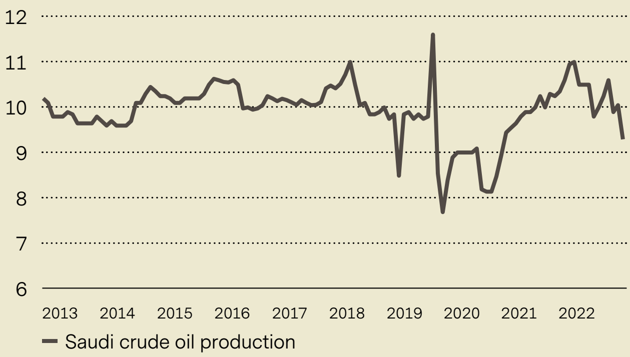
Most of the surge was attributable to supply concerns. While market participants initially had doubts about whether the Organization of the Petroleum Exporting Countries (OPEC) and its allies (OPEC+) would implement the previously announced production cuts, the publication of July data proved them wrong. According to the cartel's Monthly Oil Market Report, OPEC-13 crude oil production totaled 27.3 million barrels per day (b/d) in July, a decline of about 836,000 b/d from the previous month. This was mainly due to aggressive Saudi production cuts (–968,000 b/d), which outweighed the increase in non-OPEC+ supply, among other things (see chart 1). Saudi Arabia's announcement that it would extend its cutbacks through September and comments that the reduction may be "extended, or extended and deepened", took care of the rest. In early September, it followed through, saying it will continue curbing production for an additional three months.

Russia, which had initially produced more oil than expected, now appears to be following suit. The world's second-largest oil exporter first announced it would curb its crude oil supplies by 300,000 b/d in September, then also prolonged the reduction until December. At the same time, many US refineries increased their utilization rates over the summer months. This resulted in increased crude oil withdrawals and declining inventories, fueling concerns over a potential deficit in the months ahead (see chart 2).

Rising economic uncertainties limit upside for oil, keep base metals under pressure but support gold.
As long as the OPEC+ cartel continues to "manage" oil supply, oil prices are poised to continue to trade above the USD 80 mark. However, in the absence of unexpected shocks, excessive jumps should be limited. Global economic growth has yet to make it out of the woods and the Chinese economy is still coming to terms with various headwinds, including turmoil in its property market. These headwinds also continue to weigh negatively on base metals, the weakest commodity complex this year. Yet, gold remains well supported in an environment of rising economic uncertainty and peaking real yields.

Chart 1: Saudi Arabia currently bears the brunt of the cuts

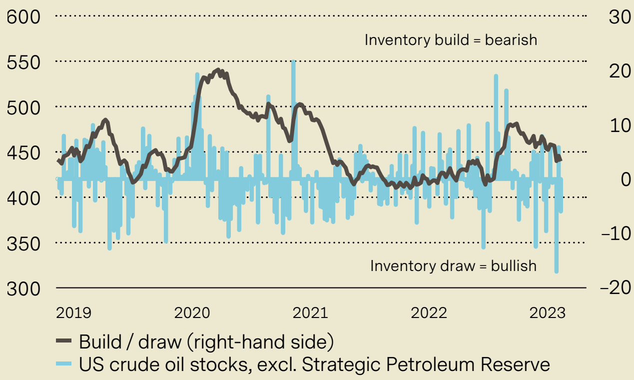
Million barrels per day



Source: LSEG, Vontobel

Chart 2: Crude oil inventories are increasingly being drawn

Barrels, in thousand — Weekly change, in thousand



Source: LSEG, Vontobel

The Fed nearing rate peak should revive bearish view of the US dollar

—
Dr. Pieter Jansen
Chief Investment Strategist,
Vontobel SFA

Elevated US interest rates, a robust domestic US economy and a sluggish foreign investment climate have collectively contributed to the US dollar's strength this summer (see chart 1). As the Fed nears rate peak and expectations of US growth moderate, the bearish view of the dollar should be revived in the second half of this year.

Narrowing growth and interest rate differentials, which were the fundamental drivers of the USD's strength since early 2021, contribute to the less optimistic outlook for the currency in the forthcoming months. Support for the dollar from an interest rate differential perspective already started to fade by the end of the year, as European central banks increased their interest rate hiking momentum relative to the Fed.

As regards the cyclical dynamics between the US and the Eurozone, the Fed leads when it comes to monetary policy. The Fed started increasing interest rates in March 2022, while the European Central Bank (ECB) waited until July 2022. The US's more advanced progress in combating inflation aligns with our view that the Fed will reach peak interest rates before the ECB and will also make the first rate cut before its European counterpart. However, there's still considerable uncertainty about these timings. More recent soft data from the Eurozone have curbed expectations of an ECB hike on September 14. Nonetheless, markets are still pricing in some minor (8bps) risk of a hike and are 50 / 50 on another 25 basis point hike before year-end. For now, our positive EUR / USD relative yield differential outlook still holds (see chart 2).

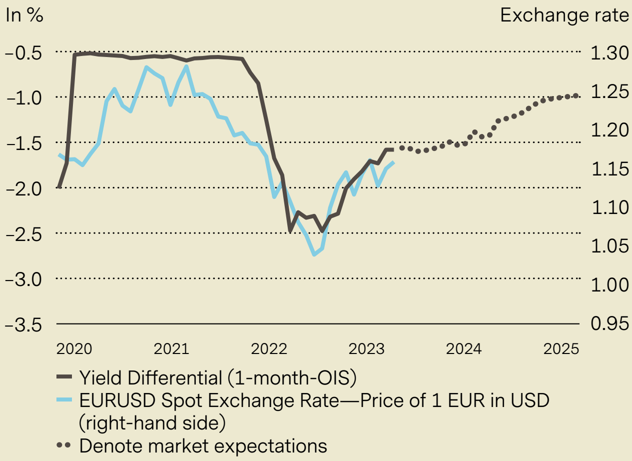
Drivers of uncertainty appear on the horizon

Earlier this year, the main concerns in the market were determining when inflation would reach its peak and estimating the associated rate peak timing. However, this issue has been resolved somewhat as we are already experiencing inflation peaks. The primary focus has recently shifted to worrying news from China, which could have significant implications for the EUR / USD market as the year progresses. If the situation in China improves, it could greatly benefit the EUR / USD. Conversely, any further post-summer setbacks could adversely affect global markets, leading to more risk-averse market behavior. This could benefit safe haven currencies such as the dollar and Swiss franc in the short term. However, unlike the Swiss franc, the dollar still appears to be overvalued versus US trading partners from a long-term perspective based on real exchange rate developments.

Chart 1: The US dollar strengthens

Source: Bloomberg, Vontobel

Chart 2: Relative yield differential still supports the bullish euro view



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	3.5	2.4	2.2
Eurozone	5.3	3.5	0.6	0.6	0.9
USA	5.9	2.1	2.6	2.0	0.8
Japan	2.3	1.1	2.0	1.6	1.0
UK	8.5	4.0	0.4	0.2	0.5
Switzerland	4.3	2.0	0.7	0.8	1.4
Australia	5.3	3.6	2.3	1.5	1.4
China	8.4	3.0	6.3	5.2	4.6

INFLATION	2021	2022	CURRENT[2]	2023 CONSENSUS	2024 CONSENSUS
Global (G20)	3.5	7.3	3.7	5.1	4.0
Eurozone	2.6	8.4	5.3	5.5	2.5
USA	4.7	8.0	3.2	4.1	2.5
Japan	–0.3	2.5	3.3	3.0	1.9
UK	2.6	9.1	6.8	7.4	3.0
Switzerland	0.6	2.9	1.6	2.3	1.6
Australia	2.9	6.6	6.0	5.6	3.2
China	0.9	2.0	–0.3	0.8	2.0

KEY INTEREST RATES (IN %)	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR	–0.50	2.00	3.75	3.89	3.41
USD	0.25	4.50	5.50	5.50	4.50
JPY	–0.10	–0.10	–0.10	–0.10	–0.07
GBP	0.25	3.50	5.25	5.60	4.95
CHF	–0.75	1.00	1.75	1.97	1.61
AUD	0.10	3.10	4.10	4.25	3.80
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	2.54	2.31	2.13
USD	1.5	3.9	4.25	3.86	3.62
JPY	0.1	0.4	0.66	0.68	0.72
GBP	1.0	3.7	4.45	4.09	3.62
CHF	–0.1	1.6	1.00	1.16	1.11
AUD	1.7	4.1	4.16	3.83	3.39

FOREIGN EXCHANGE RATES	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS END OF 2024
CHF per EUR	1.04	0.99	0.96	0.98	0.98
CHF per USD	0.91	0.94	0.89	0.89	0.89
CHF per 100 JPY	0.79	0.72	0.61	0.65	0.65
CHF per GBP	1.23	1.12	1.11	1.13	1.13
USD per EUR	1.14	1.06	1.08	1.11	1.11
JPY per USD	115.00	130.00	146.00	136.00	136.00
USD per AUD	0.73	0.67	0.64	0.68	0.68
GBP per EUR	0.84	0.88	0.86	0.87	0.87
CNY per USD	6.37	6.91	7.29	7.10	7.10

COMMODITIES	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
Brent crude oil, USD per barrel	79	86	84	84	87
Gold, USD per troy ounce	1,829	1,824	1,915	1,975	2,015
Copper, USD per metric ton	9,720	8,372	8,360	8,500	8,802

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

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