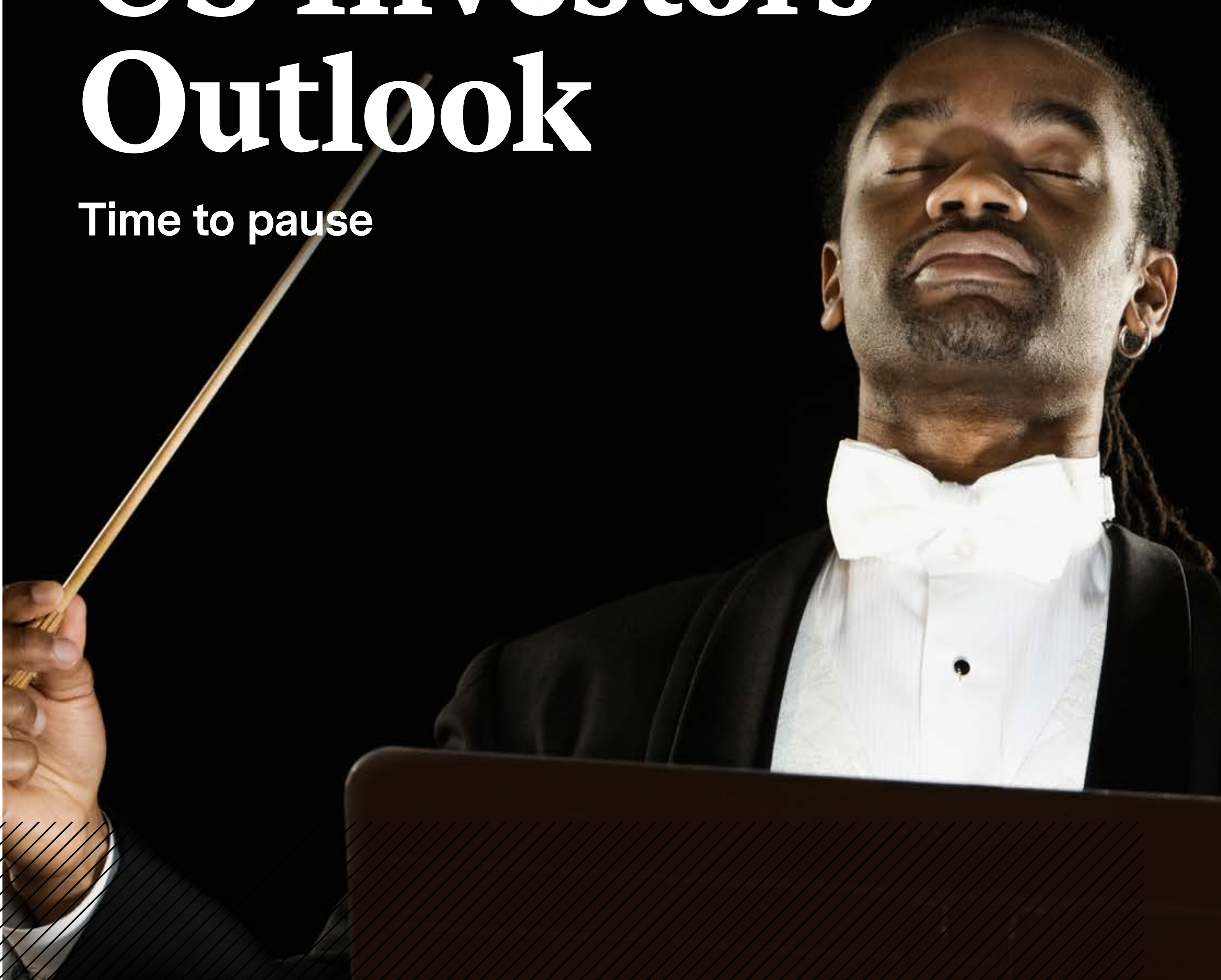
Vontobel

# US Investors' Outlook

## Time to pause



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# Time to pause

—
**Dr. Pascal Köppel**
Chief Investment Officer,
Vontobel SFA

Dear readers,

We are halfway through 2023, which is a good time for us to pause and reflect. This is exactly what the US Federal Reserve (Fed) decided to do last month, when it pushed the pause button on interest-rate hikes for the first time in 15 months and following 10 consecutive raises.

The moment many had waited for finally arrived. But while the Fed has hit the brakes for now, Chair Jerome Powell has signalled that the rate-hiking journey is not quite over yet, suggesting the prospect of two more rate increases this year.

To believe or not to believe—that is the question some investors are asking themselves, wondering whether the Fed is bluffing and questioning why the it opted to pause when it's already clear that the inflation fight will require further rate increases. Powell explained it as an opportunity to evaluate the delayed impacts of its monetary tightening on the economy so far and has emphasized that the Fed has a long way to go to get inflation bank down to its target of 2%.

We should not forget that current monetary policy is only moderately restrictive, with real Fed Fund Rates having only turned positive this year. We also have a positive impact on growth from fiscal policy and household finance. In addition, corporate balance sheets and the demand for labor are all stronger than expected before a recession. More than 25 million jobs were created since May 2020 and labor statistics show still more than 10 million open positions. Although we have an economic slowdown due to hawkish central banks, there are forces supporting growth at the same time. It may therefore take longer before we see a recession. Expectations are for around the end of 2023 or even the first half of 2024.

Global equities are more than 25% above their October 2022 lows, so that it seems the stock market is pricing a soft landing and a close to perfect economic outcome. We believe this might be a tad optimistic, given how tight lending standards have become. As we see it, slightly higher uncertainty is on the cards for the second half year and therefore more volatility. We remain cautious on equity markets, despite some interesting developments related to artificial intelligence.

In this month's Investors' Outlook, you will find an analysis of European inflation and the ECB's outlook. We also discuss the headwinds gold faces and why we expect more attractive entry opportunities in credit markets over the coming 12 months. We once again highlight the overvalued US dollar and the opportunities the strong US currency offers investors for buying its international counterparts.

After the Fed's pause, this publication is going to take some time of its own off over the summer break and will return with the September edition. In the meantime, your Investment Management team will continue to monitor the market environment for you and will be ready to take quick action if warranted.

Enjoy your vacation and take a breather.

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**Dr. Pascal Köppel**
Chief Investment Officer,
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# Pit stop: Review and outlook

**The period through the end of June has unfolded like the standard playbook of a late economic cycle: lending standards and financial conditions have tightened. The US housing market started to reveal its first cracks and jitters in the banking system followed. Default rates are likely to rise next. After an eventful first half-year, we are now focused on what the next six months might have in store.**

Central banks continue to set the tone. The most important recent event was the Fed's decision to pause interest rate hikes and investors will continue to keep a close eye on central banks' actions in the coming months. There is a lot to consider. While the Fed has started to become somewhat less hawkish, its European counterpart is still increasing rates. The European Central Bank (ECB) already mentioned that another hike is likely in July. On the other hand, some central banks in emerging markets have already started to open stimulus tabs. The People's Bank of China (PBoC) has cut its key benchmark lending rates and further stimuli seem likely.

Another major topic on investors' minds is a possible recession. The strong US labor market and accumulated pandemic savings have propped up consumers, delaying a recession. We see a greater possibility of a recession in 2024. This also leads us to believe that the Fed will pivot to cutting rates in the first or early in the second quarter of 2024. From an investment point of view, equity markets are pricing in rate cuts in the near term. We think there is room for disappointment, resulting in higher volatility and market corrections in the second half of 2023. With equity markets already assuming a near-perfect soft landing, we see a better risk reward from bonds over equities. It goes without saying that, generally, you can weather a possible storm better with a well-diversified portfolio that also contains international assets and currencies, and is well-balanced across the sectors.

Against this backdrop, we are maintaining our current portfolio positioning. You will find the details of our asset allocation on page 5.

| | UNDERWEIGHT significantly | UNDERWEIGHT slightly | NEUTRAL | OVERWEIGHT slightly | OVERWEIGHT significantly | |
|---|---|---|---|---|---|---|
| **1 Liquidity** | | → | | | | We remain 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 in 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 in high-yield bonds due to the rising odds of a recession and our outlook for the US economy. Lastly, we also remain positive on emerging market debt, supported by an expected softening of the US dollar due to a less hawkish US central bank rhetoric and the Fed's pause communicated in June. We should see lower two- and ten-year rates in the quarters ahead. |
| **3 Equities** | | | → | | | Central banks continue to be a very important driver of financial markets. As the purchase manufacturing indexes indicate positive service sectors but contracting manufacturing sectors, the 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. At this stage of the cycle, we do not express any specific regional equity preferences and remain neutral on Swiss, US and Asia Pacific developed markets. We also have a neutral allocation to Europe and emerging market equities but acknowledge their valuation discount versus the US market. |
| **4 Commodities / Gold** | | | → | | | While the precious metal's year-to-date performance remains impressive, it has softened in recent weeks. This mostly due to profit-taking by some investors. However, the longer-term case for gold remains unchanged and we are keeping an overweight allocation to gold, as it has been a systemic portfolio diversifier during times of rising market stress. Given that global economic manufacturing activity has not improved yet, we confirm our general underweight allocation to other commodities, including energy. |

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

# No time to pause for the ECB

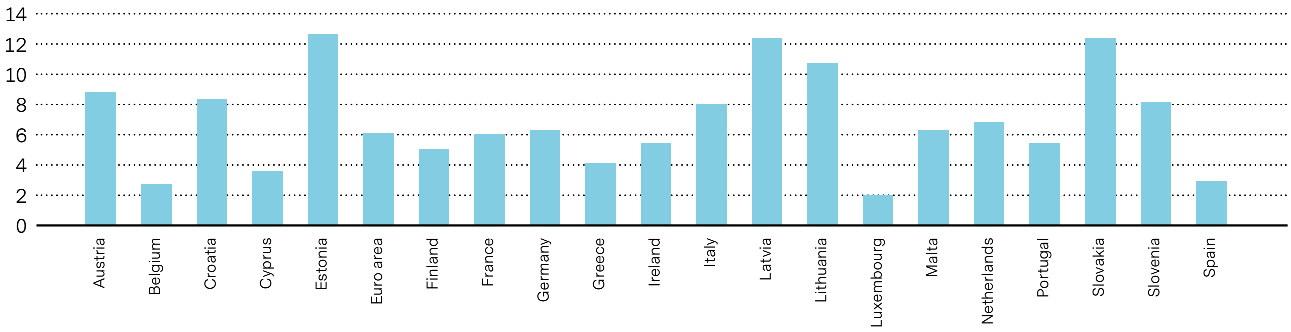
**We foresee no leeway for the European Central Bank (ECB) to abandon its tighter monetary policy, as the core inflation rate measured by the Harmonized Index of Consumer Prices (HICP) is still far above the target of around 2%. With a growing wage drift in the euro area (EA) and the ECB's recent inflation projections, the policy target can only be reached by mid-2025.**

—
**Dr. Olaf Liedtke**
Chief Investment Strategist,
Vontobel SFA

The war in Ukraine led to an energy price shock last year. Consumer price inflation surged to levels last seen in the early 1970s and 1980s, peaking at more than 10% in late 2022. As energy costs have fallen back to pre-crisis levels, headline inflation is moving towards 5%. Core inflation, excluding the volatile food and energy components, has hovered around 5% since September of last year.

The overall EA HICP is an expenditure-weighted mean across all national HICPs of the EA's member states. Therefore, national HICPs may vary across countries and significantly deviate from the EA mean. The EA HICP currently stands at about 6%. Luxembourg and Spain have the lowest inflation rate of around 3% each, while the highest inflation rates are in Estonia, Latvia, and Slovakia, at around 12% (see chart 1). There are several reasons why prices for similar products can differ across the EA. Countries may be at varying stages of the economic cycle, have different growth rates or different income- and cost-development patterns, i.e., rental accommodation costs. Another explanation is that citizens in different countries buy different products and services, and exhibit dissimilar consumption and savings behavior. The

**Chart 1: inflation EA countries**
In %



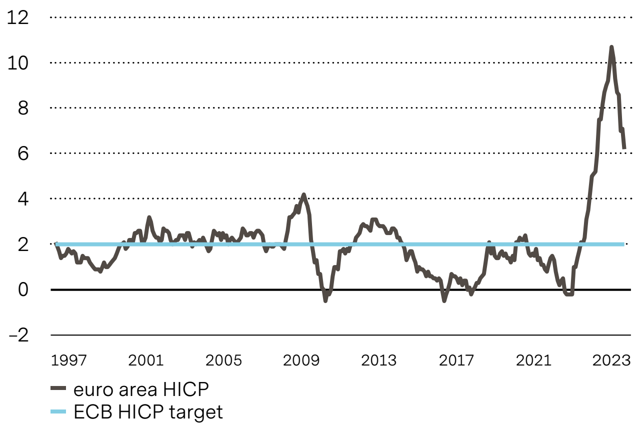

Source: ECB Statistical Data Wearhouse

multiple degrees of rigidity of national labor markets within the EA may also play an important role in explaining the contrast between national inflation rates.

There are also administrative reasons why inflation rates might differ across countries. Some prices are set or regulated by the government or local authorities (i.e., public transport costs). Changes in these administered prices or in value-added tax (VAT) can have a temporary impact on inflation. For example, a reduction in VAT will lower prices and therefore the inflation rate. There are striking differences between the US and the EA. US consumption behavior is similar across most states and regulated, or administered prices only account for a small fraction of the overall price sample collected by statistical agencies.

**Chart 2: Inflation euro area economy**

In %




Source: ECB Data Portal

The ECB aims to set a suitable path for future interest rates that curbs inflation in most EA countries. To achieve this, it is crucial to have an understanding of the origin and nature of inflationary shocks. The ECB identified a terms-of-trade shock, where inflation caused a loss of international competitiveness due to the euro's substantial appreciation. The ECB estimates that the EA transferred over EUR 200 billion (around 1.6% of GDP) to the rest of the world because of this shock. In an environment of rising input costs, businesses pass on the higher expenses to consumers to protect their profit margins. The ECB has observed that the corporate sector's response to this shock has been unusually strong compared to similar incidents. It is a well-known economic theory that companies adjust their output prices more aggressively and swiftly in the face of a broad and deep inflationary shock, given the low costs involved in adjusting prices. This makes it difficult for consumers to distinguish between inflation-driven price changes and relative price adjustments, leading to a faster and stronger pass-through of increases during the initial phase of the inflationary shock. Furthermore, factors such as pent-up demand following the pandemic, expansionary fiscal policies and disruptions in the supply chain have provided companies with greater leeway to raise prices and meet consumer demand. However, this period is now subsiding as producer price inflation has declined by approximately 40% from its peak. Corporate profits have also slowed down significantly in sectors such as construction and manufacturing, which are more sensitive to changes in interest rates, in the first half of the year.

Inflation has reduced real income and purchasing power, creating demand for higher nominal wages to compensate for the purchasing power loss. Wage setting in Europe is usually a multi-year contract; the impact on inflation will also play out over the next few years. The ECB expects that wages will have to grow by about 14% to catch up with inflation, in order to restore pre-crisis purchasing power; inflation will therefore stay higher for longer. This has forced the ECB to move its projection of a return to the inflation objective of 2% from 2024 to 2025.

Considering this persistent EA inflation, we believe the ECB will continue to raise rates. As ECB President Christine Lagarde said in a recent speech during the ECB's symposium in Sintra, Portugal, the ECB won't be able to declare rate peak anytime soon. In the short-term, higher rates may erode domestic demand but less so consumption, as the interest rate sensitivity of consumer spending in the EA is much lower than in the US. However, corporate investment spending will be hurt by higher funding costs. Nevertheless, this negative impact may be overcompensated by the need for companies to invest in climate neutral technologies given the rapid and strong regulatory climate protection changes that are being implemented in Europe. This transformation of the European climate-neutral production model offers attractive and innovative investment opportunities in Europe.

# Weighing the context for fixed income

—
**Matthias Ribback**
Portfolio Manager,
Vontobel SFA

**We continue to prefer the higher-quality end of the fixed-income market, favoring investment grade corporate debt to riskier high-yield bonds. We make frequent use of short-term government bonds in the US and Europe in order to generate attractive returns on liquidity.**

Although we find the absolute return potential in the fixed-income market attractive, we recognize that not all areas of the market are equal. We prefer the more defensive and higher-quality segments. We like government bonds for shorter-term investments, due to their high liquidity and near-frictionless trading. For medium to longer term fixed income investments, we prefer an allocation to investment grade corporate bonds that still offer an attractive yield pick-up compared to government bonds. Investing across the maturity spectrum allows us to partially lock in the current yield-environment for the years ahead.

### Appealing Treasury yields

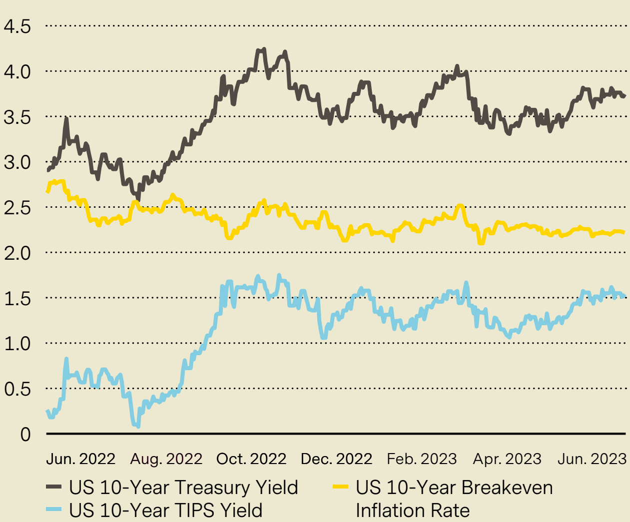
We consider the Treasury valuation appealing. An analysis of the 10-year Treasury yield and dividing it into its real and inflation compensation components shows that it hit its highest point in October 2022, coinciding with a real 10-year yield of 1.66% and a breakeven inflation rate of 2.59%. Today, the real 10-year yield is just a few basis points lower than its peak, while the inflation compensation element of bond yields has dropped considerably. This means that unless inflation rises persistently—which is not our assumption – the inflation compensation component of bond yields is unlikely to rise significantly. We believe that nominal Treasury yields have limited scope to increase further given the already high real Treasury rates (see chart 1).

### Underweight in high-yield

In the absence of a compelling valuation, increased cyclical risks to corporate profitability and associated risks of corporate downgrades and defaults, we are maintaining our underweight in high-yield.

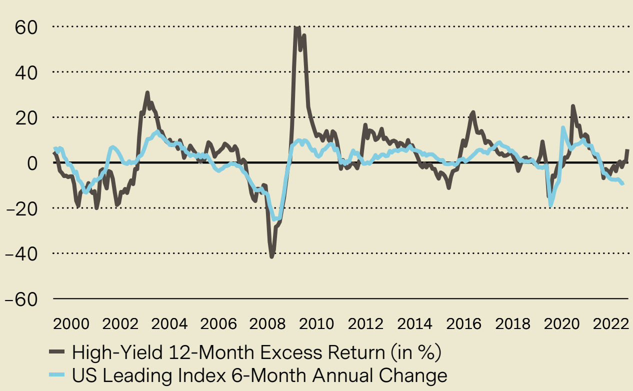
Credit markets don't appear to be any more concerned about an imminent recession than they were in the second half of 2022. The argument for a recession is straightforward—the inverted yield curve indicates that the Fed has tightened monetary policy excessively, while lower oil prices and tighter lending standards suggest a weakening economy. Historically, a decline in the demand for loans and tightening of lending standards occur only a few months before or during a recession. Given this weakening macro environment, high-yield corporate bonds are proving surprisingly robust (see chart 2). We expect credit spreads in this riskier fixed income segment to rise and anticipate better entry opportunities to present themselves over the coming 12 months.

**Chart 1: Risks to nominal yields are skewed to the downside**




Source: Bloomberg, Vontobel

**Chart 2: Corporate bond excess returns deviating from leading economic indicators**




Source: Bloomberg (truncated for excess return > 40%), Vontobel

# How sustainable is the equities' venture into bull market territory?

—
**Markus Bruhin**
Head Managed Solutions,
Vontobel SFA

**Global equity markets seem to have climbed the proverbial "wall of worry" in the first six months of the year. The MSCI All Country World Index (ACWI), which tracks some 2,900 stocks in 47 developed and emerging market countries, is up more than 14% year-to-date. Since its trough in October, the index is up nearly 27% and in bull market territory.**

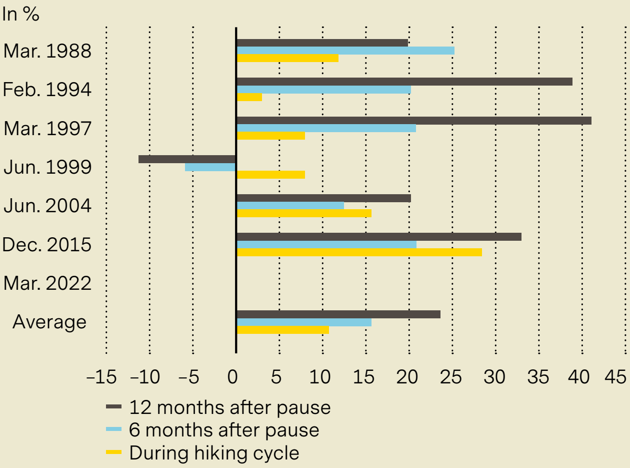
It has been a positive first half of the year with fears of a recession averted so far, allowing for some recovery in global equities after a dismal 2022. However, a look under the hood shows major divergences between countries and sector performance. The more recent intense focus on artificial intelligence (AI) also provided a narrative to fuel renewed enthusiasm for growth. AI will be the next topic in our upcoming Vontobel SFA Flash.

June was a busy month on the macroeconomic front, especially with the change and pause of the rate-hike cycle after 15 months by the Fed. Historically, this resulted in positive returns in the six to 12 months that followed (see chart 1). The resolution of the US debt ceiling and slowdown of deposit flight from US regional banks has lifted investor sentiment (see chart 2). Moreover, despite modest profit growth in many regions, equity markets have experienced upside momentum and valuations have increased despite higher interest rates.

Historically, it has not been unusual to see market rallies of up to 30 percent during periods of yield-curve inversions. Most of these preceded recessions. Meanwhile, from a structural and a bottom-up perspective, these rallies today can hardly be compared with past situations. Considering the lack of breadth and dispersion behind markets year-to-date, valuation multiples need to be put into perspective. We believe it is hard to find credible proof that "narrow markets" are a bad omen for stocks. Markets have become increasingly efficient, structurally stronger, highly cash-generative, and less leveraged by any historical comparison. Investors have recently prioritized predictable and sustainable earnings, which can be expected during periods of economic vulnerability or impending recessions. This trend is likely to continue, in light of the growing macroeconomic risks.

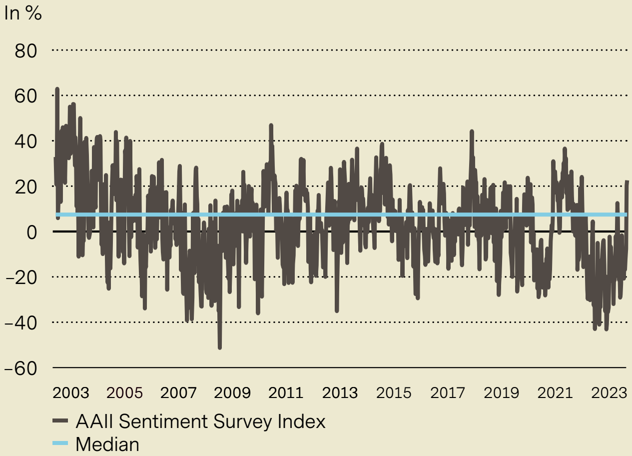
The effects of tighter liquidity conditions at a time of elevated inflation are starting to hamper the momentum in underlying economic activity. In addition, our assumptions that interest rates will be higher for longer are maintaining a cautious bias towards developed market equities in the quarters ahead. We are keeping our neutral weighting in equities.

**Chart 1: S&P 500 returns during and after hike cycles since 1988**




Source: Refinitiv Datastream, Vontobel

**Chart 2: Bulls outnumber bears by more than 20 percent**




Source: Refinitiv Datastream, Vontobel

# Headwinds for gold?

—
**Christoph Windlin**
Deputy Head
Investment Management,
Vontobel SFA

**Gold continues to boast a remarkable year-to-date performance. However, the yellow metal has recently lost some of its luster, which occurred after our recent profit taking reduction. We remain comfortable with an overweight allocation to gold.**

There are several reasons for this. First, a US default seems to have been averted after the debt ceiling was raised in early June. Second, the meeting between China's President Xi Jinping and US Secretary of State Antony Blinken raised hopes for a rapprochement between the two superpowers. Both developments are likely to have somewhat diminished the appetite for the safe-haven asset (see chart 1).

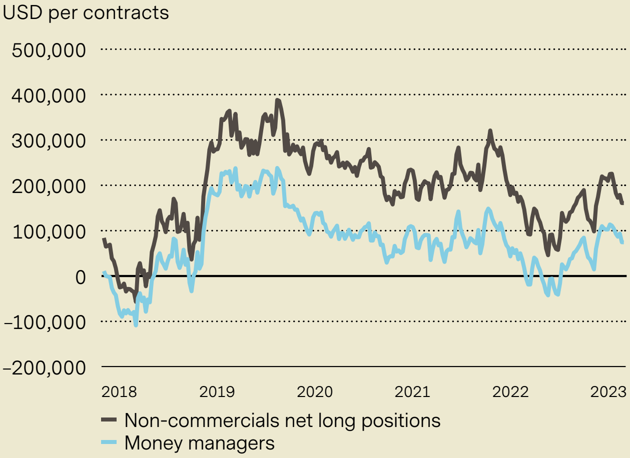
Another important reason can be found in the restrictive stance been taken by major central banks so far. For example, at the Fed's most recent meeting, Chair Powell said none of the voting members expected interest rates to be lowered by the end of the year. Further monetary tightening would clearly be negative for gold, as higher (real) interest rates increase the opportunity cost of holding the interest-free asset.

A hawkish Fed can drive the US dollar and gold, given an inverse relationship of gold with the US dollar. We expect to be closer to the end of the rate-hiking cycle and therefore don't anticipate too much long-term negative development from this side.

Demand for physical gold also appears to be stalling. For example, major Chinese consumers are reportedly exercising increasing restraint in the face of a weakening domestic economy. The country's gold and silver sales rose by "only" 24% year-on-year in May, significantly lower than in previous months.

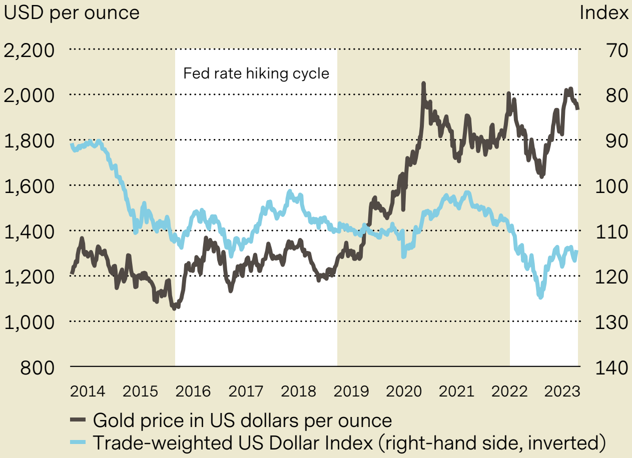
However, we believe that gold will shine again soon. First, the Fed is only postponing and not abandoning its policy shift. This has historically been a positive catalyst for gold prices (see chart 2). History shows that if a delayed recession occurs in the US, the Fed typically cuts rates. Second, heavyweight China is starting to stimulate the economy, which should also provide some support. Finally, we live in a world in which geopolitical risk is likely to remain high.

**Chart 1: Speculators have partly flocked out of the precious metal**




Source: Refinitiv Datastream, Vontobel

**Chart 2: The end of a Fed hiking cycle has historically been positive for gold**




Source: Refinitiv Datastream, Vontobel

# The US dollar's cyclical downturn has further to go

—
**Dr. Pascal Köppel**
Chief Investment Officer,
Vontobel SFA

**The US dollar, as measured by the US Dollar Index (USDX), has depreciated by around 1% over the past month (see chart 1) and has dropped by more than 10% from this year's high. This is despite the Fed's continued assertive stance, where it has communicated a strategy for rates that will be "higher for longer" to financial markets.**

The dollar is expected to depreciate as yield differentials tighten. We expect a slowdown in economic activity and inflation deceleration in the US. This should give markets certainty that we are close to the end of cycle of interest rate hikes and at the same time trigger speculation that rates could be cut in the US. The US interest-rate advantage over the Group of Ten (G10) will narrow as the Fed halts and eventually reverses its tightening campaign (see chart 2).

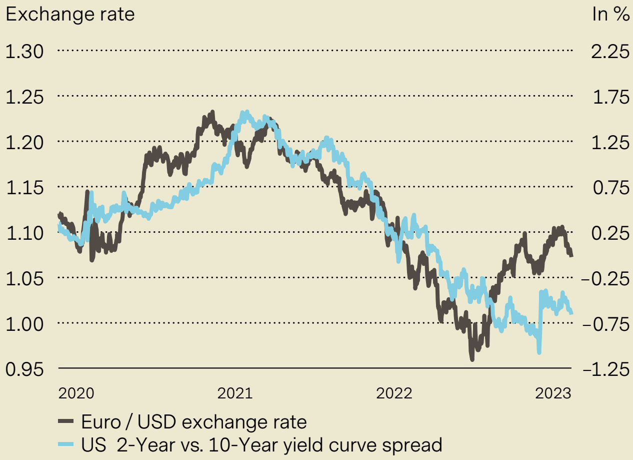
**Bullish case for the euro**
The euro has recovered against the dollar, thereby undoing much of the depreciation incurred during the sell-off in May. After hitting a low of 1.0635 at the end of May, the euro has climbed back up above 1.09, bringing it towards the top of the year-to-date range of between 1.05 and 1.10. The run of higher highs (in January and April) followed by higher lows (in March and May) so far this year highlights the fact that the bullish trend remains in place.

The ECB was slow out of the gate to tighten policy. Euro zone inflation is partially imported due to the weakness of the euro. This effect of imported inflation will disappear over time, as the euro has stabilized. Although US rates will most likely peak higher than those of the ECB, the ECB will probably still be tightening at the time the Fed has peaked. This implies that the relative yield differentials should validate more euro upside.

**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 | 2.4 | 2.4 | 2.3 |
| Eurozone | 5.3 | 3.5 | 1.0 | 0.6 | 1.0 |
| USA | 5.9 | 2.1 | 1.6 | 1.3 | 0.8 |
| Japan | 2.3 | 1.1 | 1.9 | 1.2 | 1.1 |
| UK | 8.5 | 4.0 | 0.2 | 0.2 | 0.9 |
| Switzerland | 4.3 | 2.0 | 0.7 | 0.8 | 1.4 |
| Australia | 5.3 | 3.6 | 2.3 | 1.5 | 1.6 |
| China | 8.4 | 3.0 | 4.5 | 5.5 | 4.9 |

| INFLATION | 2021 | 2022 | CURRENT[2] | 2023 CONSENSUS | 2024 CONSENSUS |
|---|---|---|---|---|---|
| Global (G20) | 3.5 | 7.3 | 6.3 | 5.2 | 3.70 |
| Eurozone | 2.6 | 8.4 | 6.1 | 5.5 | 2.50 |
| USA | 4.7 | 8.0 | 4.0 | 4.1 | 2.60 |
| Japan | –0.3 | 2.5 | 3.2 | 2.8 | 1.50 |
| UK | 2.6 | 9.1 | 8.7 | 7.1 | 2.90 |
| Switzerland | 0.6 | 2.9 | 2.2 | 2.4 | 1.50 |
| Australia | 2.9 | 6.6 | 7.0 | 5.6 | 3.20 |
| China | 0.9 | 2.0 | 0.2 | 1.5 | 2.25 |

| KEY INTEREST RATES (IN %) | 2021 | 2022 | CURRENT | CONSENSUS IN 3 MONTHS | CONSENSUS IN 12 MONTHS |
|---|---|---|---|---|---|
| EUR | –0.50 | 2.00 | 3.50 | 3.76 | 3.45 |
| USD | 0.25 | 4.50 | 5.25 | 5.35 | 4.25 |
| JPY | –0.10 | –0.10 | –0.10 | –0.09 | –0.08 |
| GBP | 0.25 | 3.50 | 5.00 | 5.00 | 4.50 |
| CHF | –0.75 | 1.00 | 1.75 | 1.81 | 1.62 |
| AUD | 0.10 | 3.10 | 4.10 | 4.50 | 3.90 |
| 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 | 2.29 | 2.41 | 2.20 |
| USD | 1.5 | 3.9 | 3.68 | 3.53 | 3.38 |
| JPY | 0.1 | 0.4 | 0.36 | 0.59 | 0.64 |
| GBP | 1.0 | 3.7 | 4.28 | 3.98 | 3.54 |
| CHF | –0.1 | 1.6 | 0.89 | 1.20 | 1.09 |
| AUD | 1.7 | 4.1 | 3.95 | 3.95 | 3.51 |

| FOREIGN EXCHANGE RATES | 2021 | 2022 | CURRENT | CONSENSUS IN 3 MONTHS | CONSENSUS END OF 2024 |
|---|---|---|---|---|---|
| CHF per EUR | 1.04 | 0.99 | 0.97 | 0.98 | 1.00 |
| CHF per USD | 0.91 | 0.94 | 0.90 | 0.90 | 0.91 |
| CHF per 100 JPY | 0.79 | 0.72 | 0.63 | 0.68 | 0.70 |
| CHF per GBP | 1.23 | 1.12 | 1.14 | 1.13 | 1.14 |
| USD per EUR | 1.14 | 1.06 | 1.09 | 1.10 | 1.12 |
| JPY per USD | 115.00 | 130.00 | 143.00 | 133.00 | 130.00 |
| USD per AUD | 0.73 | 0.67 | 0.67 | 0.68 | 0.70 |
| GBP per EUR | 0.84 | 0.88 | 0.85 | 0.87 | 0.88 |
| CNY per USD | 6.37 | 6.91 | 7.23 | 6.98 | 6.89 |

| COMMODITIES | 2021 | 2022 | CURRENT | CONSENSUS IN 3 MONTHS | CONSENSUS IN 12 MONTHS |
|---|---|---|---|---|---|
| Brent crude oil, USD per barrel | 79 | 86 | 74 | 83 | 88 |
| Gold, USD per troy ounce | 1,829 | 1,824 | 1,932 | 1,950 | 1,997 |
| Copper, USD per metric ton | 9,720 | 8,372 | 8,391 | 8,500 | 8,983 |

[1] Latest available quarter
[2] Latest available month, G20 data only quarterly
Source: Vontobel, respective statistical offices and central banks; as of June 26, 2023

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