Investment Focus

What can we expect – no landing, a soft landing or a hard landing?

Despite the failures of some smaller US banks, no changes to our asset allocation

Given the singular event of the failure of Silicon Valley Bank (SVB) and some other smaller banks in the US, we will not change our tactical asset allocation views and maintain an equity allocation close to the strategic view: i.e. staying fully invested.

Our equity exposure is regionally well diversified with only minimal directional views for specific equity markets. In the construction of our equity model portfolios, we place a strong emphasis on companies with solid business models that have the capability to generate sufficient cash flows to meet all obligations (including risk adjusted returns for capital owners). Therefore, we recommend investing into well diversified regional and sectoral portfolios and to avoid any bulk positions and holdings irrespective of the level of expected excess returns. High expected returns are usually associated with higher expected risks. These decisions should only be made by taking into consideration each individual investor's risk appetite and ability.

Finally, we are closely monitoring the development in the US banking system, including contagion and the current liquidity stress and analyzing the potential impact of these incidents on our outlook for monetary policy, especially in the US and hence for the potential impact on rates, the USD and our future tactical asset allocation. Currently, investors attach a high probability that the US central bank will slow or even take a temporary pause and we have some sympathy for this view. Such steps should calm concerns that significant rate hikes in the current situation would be like adding fuel to the fire. Rate cut expectations are, in our view, premature as the Fed primary and the ultimate goal to bring inflation back to the long-term policy target of 2% is not yet reached.

➔ [Read the full Focus Theme of 14 March 2023]

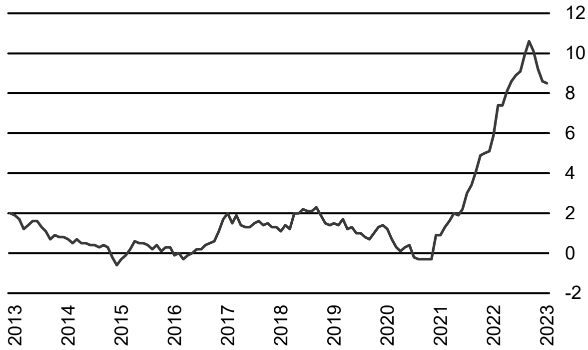
Having come up against several headwinds during the year, global economic growth remained moderate at best in the final quarter of 2022. This economic downturn was mainly attributable to stubbornly high, albeit easing, inflation, which continued to rob consumers of purchasing power, and to persistent monetary policy tightening in most advanced economies, which translated into unfavorable financial conditions for firms and private households. In turn, this led to weak economic momentum, especially in the euro area (EA), although still slightly stronger than had been expected. The German economy contracted by 0.4% in the fourth quarter of 2022.

This compared with the US, where the economy was much more resilient. Real gross domestic product in the US grew at a solid annual rate of 2.7% in the same period, driven mainly by private inventory investment and state and local government spending. Nonetheless, the underlying cyclical patterns such as the decline in construction investment and net trade remained subdued. Although unfilled orders remain high in most sectors, demand is expected to be lower on the back of tighter financial conditions. The loss of purchasing power is also putting a dampener on the current economic environment in many industrial economies. This is confirmed by a further decline in the February reading of the new orders indicator of the PMI composite index for the US. The EA economy also follows the narrative of further deceleration of economic activity in the months ahead. Optimistic investors are anticipating a soft landing or a mild recession. Pessimistic business leaders, on the other hand, are concerned that the global economy in general and the US economy in particular could slide into a severe recession or are headed for a hard landing. This would be brought about by sharp monetary policy tightening and therefore the fiscal restraint needed to curb domestic demand and tame inflation.

US inflation (all item, in %)

Source: U.S. Bureau of Labor Statistics, Vontobel SFA

Euro area inflation (in%)

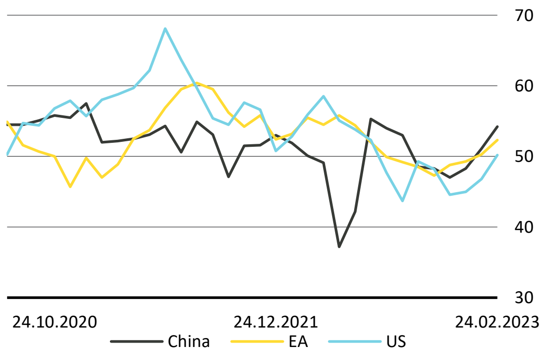


Source: European Central Bank, Vontobel SFA

Inflation in the US and the EA continued to fall gradually to 6.4% and 8.5% respectively in February. This is fueling expectations that the central banks are successfully fighting inflation without creating a sharp surge in unemployment and a severe drop in domestic demand. Investors have also learned that the passthrough from higher central bank rates to lower inflation needs significant time. The experience of the Fed's anti-inflation policy in the early 1980s shows that it can take quite some time before inflation is back at the policy target. The Fed has therefore significantly slowed its pace of monetary tightening to evaluate the impact of higher central bank rates on unemployment, inflation and economic growth over time. The ECB on the other hand still sees scope for aggressive rate hikes. Nevertheless, the downshift on tightening in the US has fueled expectations that the adverse effects of tighter monetary policy on the economy may be limited.

Against this economic backdrop, financial markets and risk assets continued to deliver a solid positive performance but at a much slower pace compared to January. European equities continued to outperform USD-denominated assets. One reason for this underperformance of USD-denominated assets might be the curbed hopes among US central bankers and members of the FOMC for an early end to the tightening cycle with potential rate cuts in the wake of a further significant deceleration of domestic demand, falling inflation and a weakening of the US labor market.

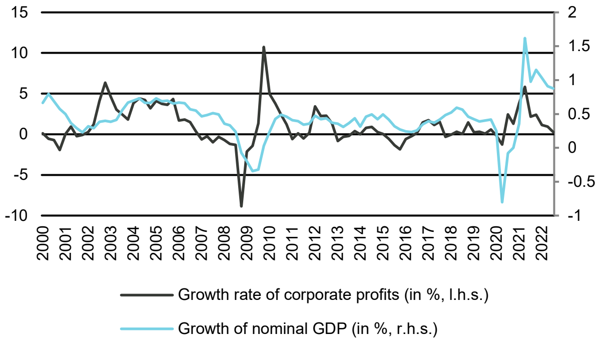
Purchasing manager indices (PMI Composite) – Back in expansionary territory
Index Points



Source: Bloomberg Finance L.P., Vontobel SFA, as of February 2023

On the one hand, higher Purchasing Manager Indices (PMI) in the US and the EA, and the Chinese economy returning to expansionary territory, have raised concerns that the global economy has digested the interest rate shocks with relative ease and has started to recover from economic weakness in the previous months. In an environment where the economy is re-accelerating in the US and with inflation running at a pace of around 6%, the Fed would be forced to step up its efforts again to combat inflation by pushing rates higher or keeping them elevated for longer. While on the other hand, rebounding economic momentum in the most important economic regions should also boost earnings expectations and support the performance of risk assets. Our own estimates of the effect of nominal GDP growth in the US on the growth rate of corporate profits shows that a one percentage point increase in nominal GDP boosts nominal corporate profits by approximately 1.7 percentage points.

Growth of corporate profits and nominal GDP

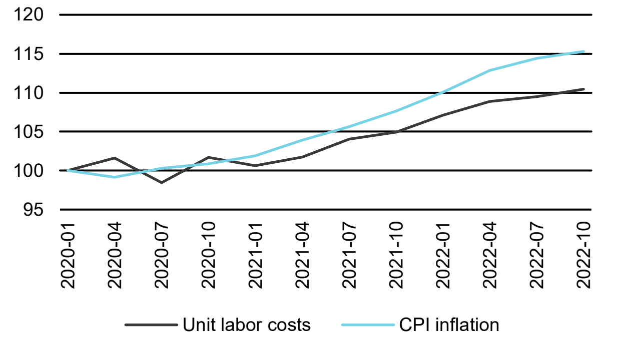


Source: US Bureau of Economic Analysis, Vontobel SFA

Tightening of monetary policy was the basic reason for the slowdown in nominal GDP growth in 11 out of 17 cases since the end of WWII in the US. In the remaining six cases other external shocks such as the outbreak of the COVID-19 pandemic were responsible for the decline. The current increase in the Fed Funds rate is around 0.5 percentage points above the average central bank tightening of 350 basis points. At the same time, this policy has lowered nominal GDP growth by approximately 4.5 percentage points and has slowed down the growth of corporate profits by around 7.5 percentage points. This corresponds approximately with the estimated multiplier of around 1.7. In the current rate tightening cycle, **nominal** GDP growth had decelerated already by approximately 5 percentage points from around 12 to 7% in the third quarter of 2022, while corporate profits had already lost about 7% percentage points. This is close to the level implied by the estimated multiplier.

These simple statistics and metrics suggest that the Fed's tighter and tightening monetary policy stance has already had a noticeable impact and the US economy has shifted to a lower gear. Whether this loss of economic momentum is already sufficient for inflation to moderate further is still an open question, especially as the US labor market remains in very robust shape. US initial jobless claims have averaged approximately 190,000 since the beginning of this year. This is far below the mean of 250,000 during 2017 when the US economy expanded at a rate of around 4%. Labor demand exceeds labor supply by about 3 percentage points of the civilian labor force and job openings, another measure of US labor market tightness, is still hovering above 10 million. The Peterson Institute of International Economics in the US estimates that the current unemployment rate consistent with a constant inflation rate (non-accelerating inflation rate of unemployment – NAIRU) should at least rise by 2 percentage points above the current unemployment rate of 3.5%. As current unemployment stands at around 6 million, it would require an increase of approximately 3 million to raise the pool of unemployed people to around 9 million (for 5.5%).

US inflation and labor costs (rebased January 2020 = 100)



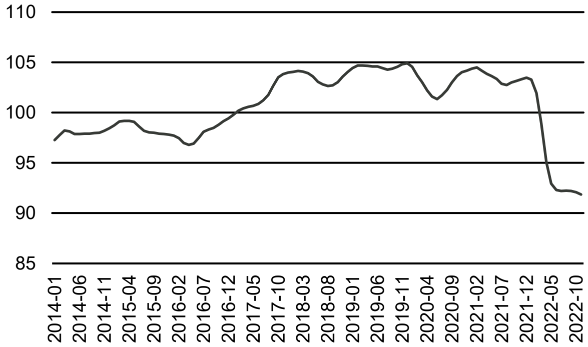
Source: U.S. Bureau of Labor Statistics, Vontobel SFA

However, the US economy is not facing a *real wage* (i.e. adjusted for inflation) problem. Since the outbreak of the COVID-19 pandemic, nominal wages increased by approximately 9 percentage points while inflation surged by around 15 percentage points, resulting in a 6 percentage point decline in real wages. According to the US Bureau of Labor Statistics, all sectors of the US economy experienced a similar negative real wage development, which has helped corporate America to maintain its profitability despite the negative trends in labor productivity.

Overall, our base case scenario "Decelerating economic activity and gradually falling inflation" relies on the assumption that economic growth is expected to decelerate further, supporting monetary policy to reduce inflation back to the policy target. As we see it, US monetary policymakers acknowledge that higher interest rates will impact on the real economy with a time lag and will therefore keep tightening at a slower pace. Once the terminal rate is reached, rates will likely stay higher for longer. In EA, the ECB continues to hike rates as inflation has not yet peaked; this peak should be reached in the coming months. We believe the ECB may also keep rates high for longer to ensure that inflation moves towards its long-term policy target.

The reopening of the Chinese economy is positive for the development of the global economy and should support exports from the advanced economies to China and, by the same token, imports to the advanced economies from China. Fiscal spending in China should help its economic growth to return to around 5% in 2023, which has been the average of the past few years. However, the speed and strength at which consumption could rebound post reopening is one of the most frequently asked questions among investors in China. The country has seen a consistent rapid rebound in high-frequency mobility indicators such as traffic congestion in recent weeks, while consumer confidence has been muted after three years of a zero-COVID policy and an eighteen-month property slump.

Consumer confidence in China – No recovery yet



Source: OECD, Vontobel SFA

It might take much longer for broad-based consumption to recover. Except for the US, consumption in other major economies such as EA, Japan and Korea have not yet recovered to pre-COVID trend levels according to the Organization of Economic Cooperation and Development (OECD). The consumption gap (vs trend) closed at a slower pace in Hong Kong and EA than in Korea and Taiwan, as Hong Kong and EA faced other growth headwinds, such as weak Chinese growth and energy shortages respectively. The recovery path of broad-based consumption suggests that besides the relaxation of COVID restrictions, other macro factors might affect this recovery.

Mechanically, consumption is a function of income and wealth or accumulated bank deposits. We expect household income growth to recover in 2023, although the pace of recovery could be slightly slower than the recovery of GDP growth overall or quite similar to the scenario we saw from 2021 to 2022. We also expect to see a lower savings rate in 2023, albeit declining only to pre-COVID levels rather than dipping below, as it did in 2021, and similar to Hubei in 2020 and Shanghai in 2022 after the strict lockdowns ended.

In contrast to other economies such as the US, excess savings in China during the pandemic appeared to be quite low, amounting to less than 3% of GDP based on OECD estimates. Unlike other major economies such as the US where the government subsidized household sectors, excess savings in China were accumulated only from reduced spending during pandemic periods. These excess savings could potentially support consumption this year. However, we notice that households may have piled their excess savings into time deposits, which are unlikely to be withdrawn before maturity.

Asset allocation: still too early to add more risk to our portfolios

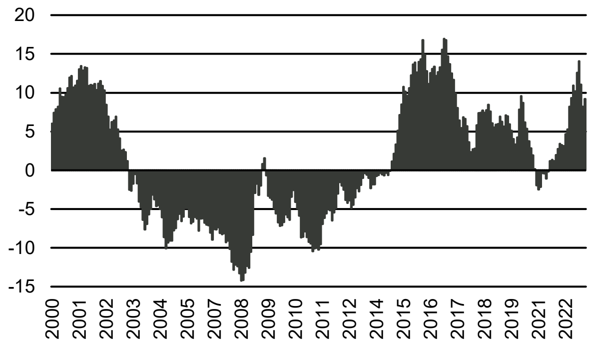
Foreign exchange: will USD strength come to an end?
Against a macroeconomic backdrop of gradually declining inflation, tight monetary policy and continued uncertainty about the extent of the deceleration of economic activity, we decided to keep our risk exposure unchanged.

Real effective exchange rate of the USD (index)

Source: Bank of International Settlement, Vontobel SFA

With the start of the European sovereign crisis in 2010, the USD began to appreciate. Over this decade, the currency gained around 50% in real effective terms against a basket of 62 currencies from advanced economies and emerging markets. According to the Bank of International Settlement (BIS), this strengthening trend has led to an overvaluation of the USD by approximately 15%. Does this imply that this overvaluation might revert immediately? There are plenty of reasons why the USD may defend its strength. It still has a significant interest rate advantage over other currencies from the advanced economies. Elevated geopolitical and economic uncertainty play into the hands of the greenback as a safe haven currency. During the past decade, the US economy generated superior earnings growth. All these trends continue to persist. Nevertheless, a few other factors suggest that the period of USD strength may come to an end.

Over- and under-valuation of the real effective exchange rate of the USD (in % relative to past five years)

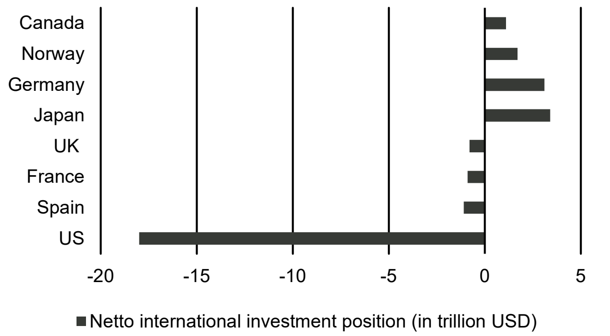


Source: Bank of International Settlement, Vontobel SFA

The interest rate advantage of the USD is shrinking as other central banks have also abandoned their zero-interest rate policy and are now actively fighting inflation. Some investors already see the terminal rate of EA central bank rates at around 4%, as inflation is lagging the US inflation trend by approximately six months. While service inflation in the US proves stickier than expected, goods and food inflation are far from peaking and require considerable attention from the ECB. An even more aggressive policy stance cannot be ruled out if these inflation drivers continue to rise. Geopolitical concerns with respect to the war in Ukraine have already started to abate in favor of less safe-haven currencies. Should the uncertainty about the future direction of the global economy also fade in the foreseeable future, the demand for more cyclically exposed currencies should increase. Since the beginning of this year, international assets such as equities have outperformed USD-denominated assets.

Structural, long-term developments also speak for further diversification out of the USD. The US is by far the largest borrower in the world. The international investment position (the accumulated value of US-owned financial assets in other countries and U.S. liabilities to residents of other countries at the end of each quarter) has reached USD 18,000 billion or 100% of USD GDP. For Germany and Japan, this measure stands at a plus of around USD 3,000 billion each according to the International Monetary Fund (IMF). These countries are followed by Hong Kong, Taiwan, Canada, Norway and Singapore.

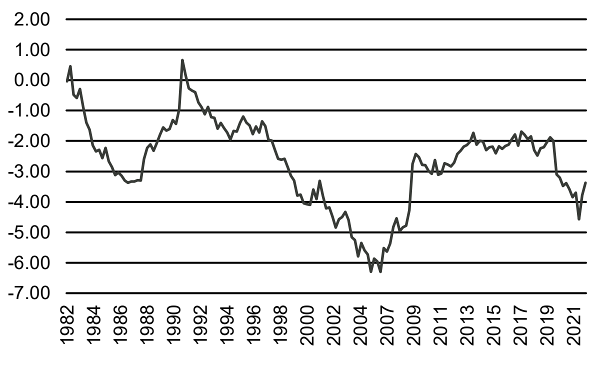
International investment position for selected economies



Source: International Monetary Fund, Vontobel SFA

The current account balance is another measure of an economy's international debt situation. If an economy systematically runs a current account deficit, this tells us that the economy in question relies on foreign savings to fund the respective excess of domestic demand. This development of an accumulating current account deficit feeds into an increasingly negative international investment position. Since the early 1980s, the US current account deficit has averaged approximately 3% annually, while currently the US is running a deficit of around 4%.

US current account in % of GDP



Source: Federal Reserve Bank St. Louis, Vontobel SFA

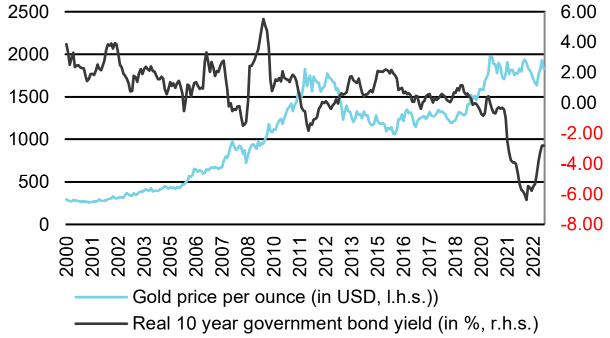
All things being equal, if an economy such as the US systematically runs a current account deficit, it needs to exchange its domestic currency for foreign currencies, implying a potential depreciation of the home currency. In the case of the US, which has the world currency for international trade and investments, the USD is less exposed to excess supply. But at some stage, investors may demand a risk premium for holding the Greenback, whereby it could start to depreciate, especially after years of strength. We therefore advise investors with a strong USD home bias to gradually start diversifying into international currencies to benefit from those that are currently cheap versus the USD.

In addition, we hold overweight allocations to the NOK in our global mandates and to the SEK in our international portfolios. In both economies, inflation continues to rise, and one-year inflation expectations are approaching 6% in Norway and Sweden respectively. Current central banks rates in Norway stand at 2.5%, implying negative real rates of around 3.5% that are much too low to tame the inflation genie. The policy rate in Sweden was fixed at 3% in February, leaving the real rate at -6.3%. We expected further aggressive tightening by the Norges Bank and the Riksbank to drive inflation in both countries back to the policy objective of 2% over the medium-term. A falling inflation premium should support both currencies against our reference currencies, especially as both the NOK and the SEK are supported by low outstanding government debt, healthy current account statistics and high economic competitiveness. Although we are keeping the underweight allocation to global commodities, we continue to overweight gold. The main headwind for the yellow metal for most of 2022 was the strength of the USD. 2023 started off on a different note and the gold price per ounce had a strong start to the year. During January, expectations for a slowdown in the pace at which the Fed would raise rates, combined with growing concerns about economic growth, put pressure on the USD and supported gold. In addition, as US Treasury yields dropped, gold rallied and reached a high of USD 1,959.72 on 2 February 2023.

After the strong uplift, gold and other commodities sold off sharply on the back of a reassessment of Fed hikes and softer Chinese macroeconomic growth expectations, with both factors combined leading to a resurgence of the USD. While gold initially looked set for a favorable environment in 2023, the surprising strength of US economic activity and inflation figures drove a change in the FED's rate hike path. This change in perception negatively impacted the gold price per ounce. However, despite these challenges, the underlying strength of gold's fundamentals should not be overlooked. Various risk factors impact the demand for gold, such as real interest rates, debasement risk, sovereign balance sheet risk, geopolitical risks and other market tail risks. These factors matter to gold because it is a safe-haven asset that investors turn to during times of uncertainty.

The World Gold Council recently published gold demand statistics. Central banks bought 1,135 tons during 2022, the second highest year of net central bank gold purchases on record since 1950. On 27 January 2023, the IMF wrote in a working paper "gold appeals to central bank reserve managers as a safe haven in periods of economic, financial and geopolitical volatility, when the return on alternative financial assets is low".

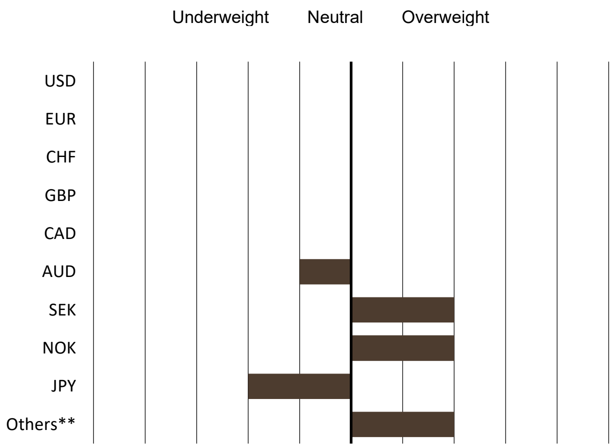
US real 10 year government bond yield and the gold price



Source: Federal Reserve Bank St.Louis, Bloomberg Finance L.P., Vontobel SFA

The long-term positive outlook for gold is driven primarily by the wealth effect, as measured by the trade-weighted US dollar. In theory, when the economic outlook for China and the rest of the world improves, the Chinese yuan and Indish rupee should rally, improving the purchasing power of China and India, the world's two largest gold buyers. This dynamic should be reinforced further by China's reopening.

Currency preferences* (six months)

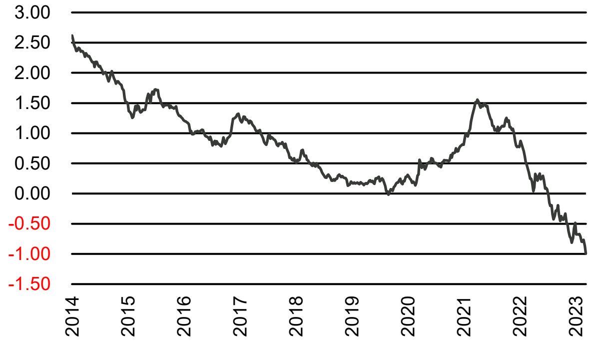


Source: Vontobel SFA, March 2023
*Shows the preferences of international currencies vis-a-vis the USD
**Refers mainly to local emerging market currencies

Fixed income: we still prefer local and hard currency-denominated emerging market debt

We maintain an overweight allocation to fixed income investment. Government bond yields have risen substantially over the past 12 months, providing attractive expected returns. Given the inverted US yield curve, we prefer shorter to intermediate maturities as short-term bond yields offer higher expected returns than long-duration bonds. In our Swiss franc and EUR-denominated fixed income portfolios, we allocate equal amounts across the entire spectrum of intermediate maturities resulting in a neutral duration strategy.

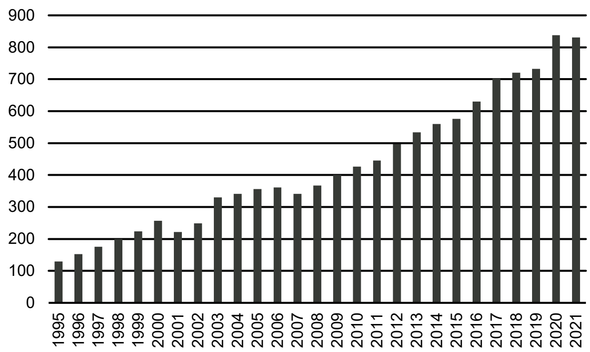
US yield curve (difference between the 10- and 2-year government bonds, in percentage points)



Source: Federal Reserve Bank St. Louis, Vontobel SFA

Investment grade corporate debt spreads have not widened tremendously during the past year. However, current spreads of around 150 basis points offer an attractive risk-adjusted yield pick-up, as we do not expect a significant deterioration of future default events. We acknowledge that the current yield pick-up offers limited spread compression potential, but most bond issuers have solid balance sheets and should cope with a shallow slowdown. Non-investment grade corporate bond spreads do not compensate for the respective default risk, which is why we are keeping an underweight allocation. We still favor local and hard currency-denominated emerging market debt, as this sub-asset class does offer attractive rating-adjusted returns. It may also benefit from a correction of an overvalued USD and potentially declining bond yields as inflation continue to inch down. The performance of emerging market economies should be supported by our constructive economic outlook; we do not foresee a severe downturn of the global economy and expect it to return to its growth trend in late 2023. Although hard currency-denominated emerging market debt increased markedly in recent years, according to data published by the BIS, we do not anticipate any turmoil in the emerging market debt market, as most emerging market economies have abandoned their currency pegs and most of their currencies are now free-floating. They have also raised their currency reserves to overcome potential depreciations caused by capital outflows in times of economic and geopolitical stress.

Foreign currency government debt in the emerging market economies, in billion USD



Source: International Monetary Fund, Vontobel SFA

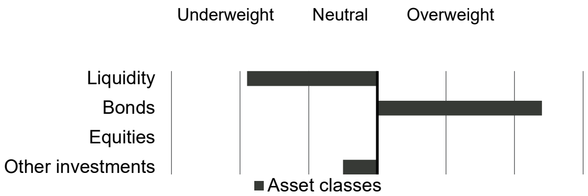
Equities: at our strategic allocation weight

Since the end of September 2022, equity markets have rallied substantially due to a variety of positive factors, such as signs of moderating inflation in the US and Europe, a weaker USD, the reopening of the Chinese economy, the easing of supply chain constraints, better-than-expected economic data, falling energy prices along with the milder than expected winter season across Europe. These factors have raised the odds of a soft landing instead of a deep recession, which has positively impacted investor sentiment and caused them to increase their holdings of risky assets. In early January, decreasing yields and a somewhat less hawkish than expected Federal Open Market Committee (FOMC) meeting in February caused a substantial shift into more (early) cyclical and growth-oriented sectors. In addition, growth, quality and small-size styles have outperformed value, yield and momentum styles, leading to an outperformance of European versus US equities.

In the meantime, US equities have rolled back from the mid-February 2023 peak as investors were forced to confront weak Q4 2022 earnings, stickier-than-expected inflation and a Fed that is seeking alternative options for keeping interest rates higher for longer. Financial markets have adjusted their view on interest rates too and are now more aligned with the Fed's "higher-for-longer" view.

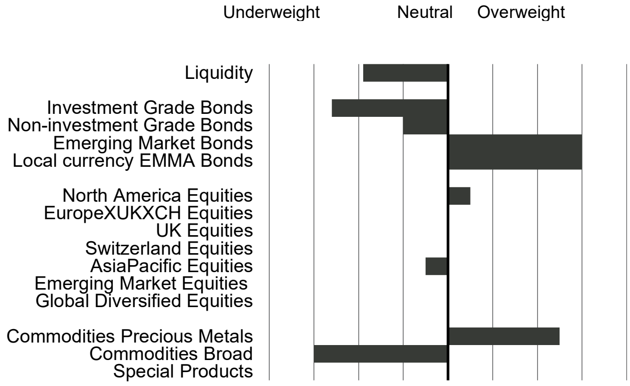
European equities look different. Since reaching their peak in mid-February, they have traded in a sideways pattern. Recession worries are receding as global growth stabilizes, combined with falling energy prices and China's reopening process. In addition, overall earnings have not been as bad as feared. Robust final demand combined with strong pricing power have supported top line growth, helping to mitigate the drag from higher costs on margins. Earnings call transcripts of companies show that they are now more optimistic about the economic outlook than in previous quarters but remain cautious on demand and wage inflation. Additionally, companies expect more headwinds from these two factors, which could lead to an erosion of margins during fiscal year 2023. Nevertheless, companies expect both higher capital returns and capex investments.

Asset class preferences



Source: Vontobel SFA, as of March 2023, based on PM Global Balanced USD

Sub-asset class preferences



Source: Vontobel SFA, as of March 2023, based on PM Global Balanced USD

Against this backdrop, we decided to keep our current risk exposure and maintain an equity allocation close to the strategic weight. Uncertainties remain high with respect to the global economic outlook, the geopolitical developments in Ukraine and the relationship between the US and China. It remains to be seen if the current downward revision of earnings growth by 10% for this and the coming year respectively is sufficient to capture the potential outcome of the expected deceleration of economic activity. We therefore remain comfortable with our current asset allocation at the strategic weight. 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, given the close interrelationships across the global economy. Nevertheless, should risk asset markets continue to deliver superior returns, our portfolios will benefit gradually from market performance. For this reason, we recommend staying fully invested and we will use our cash holding to invest whenever opportunities emerge.

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