Vontobel

US Investors' Outlook

A crude awakening

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A crude awakening

—
Dr. Pascal Köppel
Chief Investment Officer,
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Dear readers,

September delivered a bolt from the blue to market dynamics.

Along with investors' current concerns about inflation, a recession and central banks possibly making a mistake by hiking interest rates too high and for too long, the global economy and policymakers have been thrown an extra ball to juggle: surging oil prices.

Supply-driven oil price increases are usually the more painful ones for economies. At a time where inflation normalization was finally gaining some traction while growth is weakening, it now seems as if another spanner has been thrown in the works of the robust economy.

While we are not (yet) too concerned about a significant increase, the surge in the price of oil has already left its mark on the latest inflation data. However, we believe that central banks will look past these temporary price increases—at least for now—as they focus mostly on core inflation, which has fallen. The US Federal Reserve held rates steady at its September meeting, and while Chair Jerome Powell signaled that rate hikes are nearing an end, he also hinted at a higher-for-longer environment next year as a soft landing looks increasingly feasible.

September was certainly a challenging month for financial markets. Although the Fed hit pause, bond yields continued to rise. The ECB surprised the market by not pausing, but given the stubbornness of core inflation, it is certainly in a less comfortable seat than the Fed.

The diverse macro, oil and interest rate uncertainties led to increased equity market volatility. Although not at alarming levels, the US equity market volatility index (VIX) rose to nearly 19 points. While it is still quite a bit below the peaks of March 2023 (26 points) or of 2022 (36 points), it does indicate growing nervousness among investors. Equities suffered as bond yields rose further.

There was not much to report on the growth side. While there were some early signs that the global manufacturing sector may have seen the worst, there were also indications that other parts of the economy are starting to slow down. One of these is the US labor market, where a combination of various labor market statistics show a gradual weakening from very strong to strong levels.

Going forward, macro uncertainties are likely to increase further. It remains to be seen whether oil prices will exacerbate this. After all, the price increase is mainly carried by supply effects and investor sentiment rather than demand. Regarding bond yields, it is also hard to see that these increases can be sustained. Assuming ongoing inflation normalization and central banks pausing against a background of sluggish growth, the risks to bond yields are mainly to the downside. This still provides investors with an interesting opportunity to expand fixed income exposure, lock in the higher yield and provide protection to the portfolio.

Regardless of whether oil's run is short-lived or more persistent, we believe it is now the time to play a steady hand as the system is shaken.

—
Dr. Pascal Köppel
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—
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Higher energy prices but growth and core inflation decline set to continue

September kicked off with a surprise and set the tone for the month's market developments. The announcement by the Organization of the Petroleum Exporting Countries (OPEC) to extend voluntary cuts in oil production to the end of the year—longer than investors had expected—created more uncertainty surrounding the inflation normalization path.

US consumer prices rose to 3.7% in August from 3.2% in July. They reached 5.2% in the Eurozone, which was slightly less than initially estimated but still well above target. However, provided these price increases do not feed into other products, central banks will likely look past this. In addition, higher energy prices may also weigh on economic activity.

Economic uncertainty remains high. We are seeing pockets of regional (Europe, China) and sectoral weakness (manufacturing). In the US, there are growing signs of continued normalization of the labor market, although it remains strong by historical standards. US economic growth is generally slowing, which is also reflected on the corporate side. 69 US companies defaulted on their debt payments during the first eight months of 2023, which is a threefold increase over the prior-year period. 16 defaults were counted in August alone, the highest tally since 2009 and more could be on the way.

Even though the jury is still out as to whether we are heading for a (mild) global recession or can avoid one, it remains clear that global macro uncertainty continues to rise as consumers and businesses deal with higher interest rates and higher energy prices once again. In our view, this still warrants a preference for duration and quality.

We are comfortable with our current portfolio positioning and therefore see no reason to make any amendments at present. See details of our asset allocation on page 5.

	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 in investment grade (IG) credit, supporting our belief that current spreads offer a fair value risk-adjusted expected return, provided the global economy can avoid a severe downturn. We also remain underweight in high-yield bonds. In our opinion, companies with weaker balance sheets and a higher dependence on external borrowing are more at risk and their bond prices do not compensate for that 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's pause communicated in June. We should see lower two- and ten-year rates in the quarters ahead and therefore recommend extending duration slightly in investment grade bonds.
3 Equities			→			Central banks continue to be a very important driver of financial markets. Global growth is holding up overall, despite some regional and sectoral weaknesses. In the scenario of a delayed recession, we therefore believe that an allocation to equities close to the strategic weight is still appropriate. We have introduced a defensive tilt via an overweight in Swiss equities versus underweight UK equities. While having no regional preference for US, Asia Pacific developed markets, Europe and emerging market equities, we acknowledge the valuation discount of Europe and emerging markets.
4 Commodities / Gold			→			Q3 commodities' performance improved with the help of tight energy supply conditions. However, as the global economic manufacturing component has not yet improved, demand will stay weak. We confirm our general underweight allocation to other commodities. The precious metal complex performance year-to-date remains positive but it softened in Q3. Nonetheless, 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 ↘

Fiscal hangover

Hardly a day has gone by in recent months without mentioning a possible US recession. Some investors pointed to the deeply inverted yield curve and others to weakening leading indicators, such as the Purchasing Managers' Indices. Other investors again cited the New York Fed, whose models predict a 60 % probability of a recession. However, with the "most anticipated recession ever" having yet to materialize, we might see a soft landing after all.

—
Dr. Pieter Jansen
Chief Investment Strategist,
Vontobel SFA

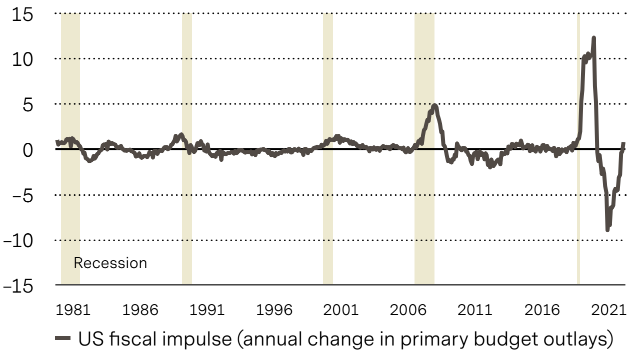
At first glance, one can quickly identify the reasons behind this delay. For one, the labor market is more robust than expected, with companies retaining existing employees or even adding to their workforce. Private consumption has also proven stronger than expected. There is also a third factor that has received little attention so far: support in the form of fiscal stimulus.

This fiscal stimulus is surprising, and some might question whether it is time to tighten the belt after former President Donald Trump's tax cuts (in place since 2017) and the generous pandemic-related stimulus packages (in place since 2020). Given the strength of the labor market, is stimulative fiscal policy necessary when the labor market is this resilient? Looking at government spending excluding interest payments, the fiscal impulse measure turned positive in the second quarter of 2023, leading to growth momentum (see chart 1).

There are several reasons for the growing US fiscal deficit. On the one hand, "Uncle Sam" has had to contend with considerable additional spending in recent months, on education (one-time student loan forgiveness), health care (Medicare), national defense (war in Ukraine) and social security. Government revenues are also no longer as abundant as before. While the US has enjoyed massive

Chart 1: The US fiscal impulse turned positive in Q2 2023

In % of gross domestic product



Source: LSEG, Vontobel

capital gains (and the taxes levied on them), especially in recent years, tax revenues have fallen with the mixed financial market performance in 2022.

Less help from Uncle Sam ahead

We are likely to see further fiscal stimulus in 2024, thanks to budget bills that have already been passed; these include the Creating Helpful Incentives to Produce Semiconductors (CHIPS) and Science Act, which aims to boost investment in domestic semiconductor production capacity, the Infrastructure Investment and Jobs Act, which focuses investing in roads, bridges and water infrastructure and the Inflation Reduction Act, which aims to curb inflation and invest in clean energy and research and development. The outcome of the US elections in November 2024 is unlikely to affect these spending bills.

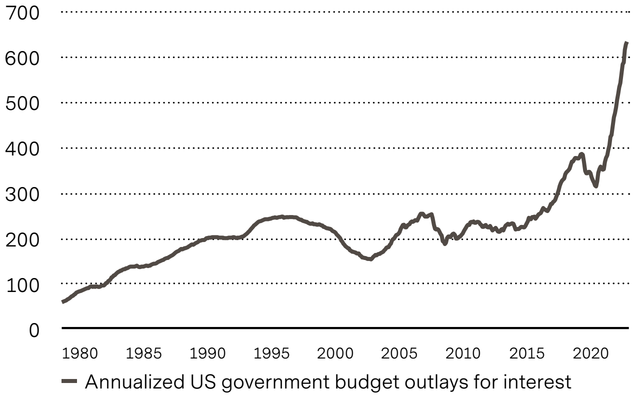
However, we expect fiscal stimulus to peak soon. US voters are becoming increasingly critical of deficit spending. A Pew Research Center poll showed that 57% of those surveyed think reducing the budget deficit should be a top priority, up from 45% in 2022. Republicans found deficit reduction significantly more important (71%) than Democrats (44%). The Supreme Court's decision in June to rule the planned partial forgiveness of student loans—one of President Joe Biden's key campaign promises—unconstitutional means borrowers had to resume repayments in early September. The measure would have cost the state roughly USD 400 billion, according to the budget office.

In addition, the US faces higher debt and increased costs to service that debt. According to the US Treasury, annualized interest outlays have soared to USD 628 billion in July 2023 from USD 313 billion in April 2021. This leaves less room for spending in other areas (see chart 2).

High fiscal deficits also remove the flexibility to support the economy if the global economy does in fact slip into a recession. Other countries are expected to reduce their deficits from 2023–2025 according to a Bloomberg survey (see chart 3). Although it became quite acceptable to interfere in the economy with fiscal spending during the Covid-19 crisis, most countries are rather slow to reduce these deficits during better times. This reduces fiscal flexibility when faced with economic headwinds, with Switzerland being a notable exception.

Chart 2: Interest costs are surging amid higher rates and high debt

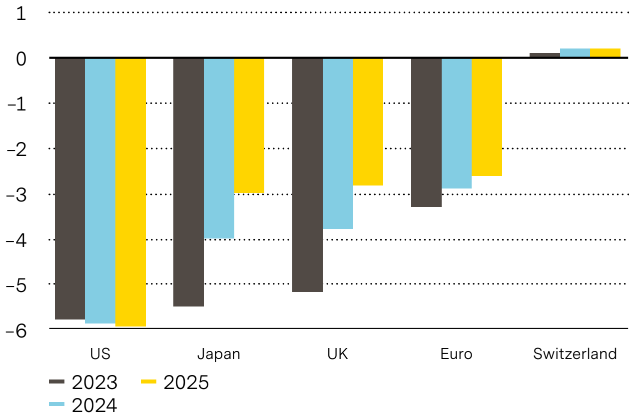
In billion US dollars



Source: LSEG, Vontobel

Chart 3: Most countries are still dealing with too high fiscal deficits

Fiscal balances as % of GDP expectations



Source: Bloomberg, Vontobel

A steep climb

—
Matthias Ribback
Portfolio Manager,
Vontobel SFA

We reiterate our constructive view on investment-grade fixed income and maintain a defensive stance towards the high-yield segment. Within investment grade bonds, we favor corporates over treasuries, especially for medium and longer-term maturities.

The Treasury market selloff throughout August and September was partially influenced by a surge in bond issuance. However, the predominant factor was the market adjusting its expectations about the trajectory of monetary policy. Over the course of one month, the 10-Year US Treasury yield surged over 75 basis points, climbing from 4% to its current rate of 4.75%—a peak not witnessed since 2007. This increase is largely attributed to a rise in real yields (see chart 1).

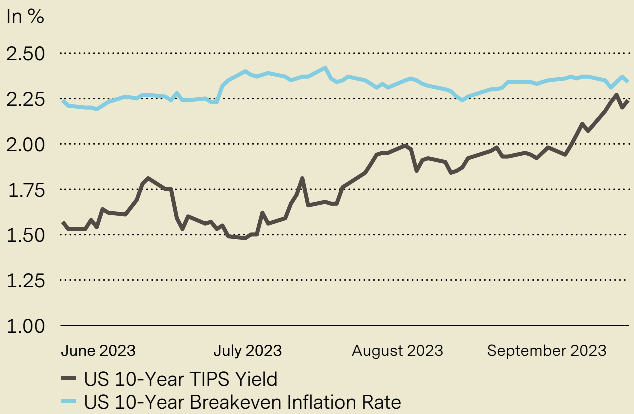
The outlook for economic growth has remained robust and yields have reacted to positive surprises in growth, while overlooking negative surprises in inflation. The Fed is thought to be close to concluding its most aggressive monetary policy tightening effort in 40 years. We believe that interest rates in the US are now sufficiently restrictive to bring inflation back down towards the Fed's 2% target. Our constructive view on fixed income centers around an anticipated less hawkish stance from the Fed, which we believe will result in a bullish steepening of the yield curve. A steeper curve provides investors with a better reward for taking on longer duration.

Credit fundamentals continue to weaken

Interest coverage ratios among junk-rated corporates have fallen from high levels (see chart 2), reflecting a significant increase in interest expense, which is now growing at a rate not seen for over two decades. The interest coverage ratio is a financial metric that helps determine how easily a company can pay its interest expense on outstanding debt. A high interest coverage ratio indicates that the company can easily meet its interest obligations, because it has significant earnings before interest and taxes relative to its interest expense. A low ratio suggests the opposite, indicating potential financial distress if earnings decline.

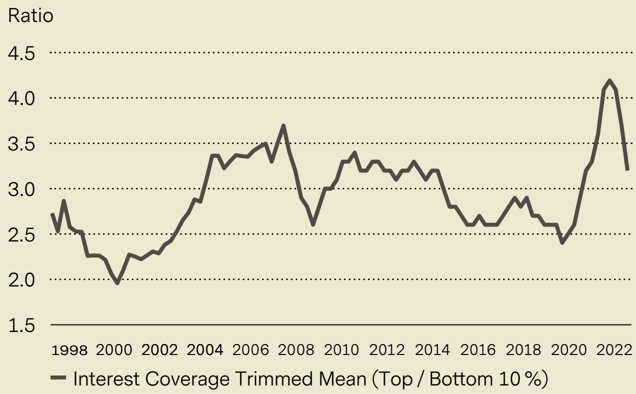
Given the uncertain economic trajectory and declining credit fundamentals in the high-yield sector, we prefer to remain invested in the investment grade segments of the fixed income market. High-quality corporate bonds still offer a credit spread of around 70 basis points, a reasonable compensation for the modest credit risk the investor bears.

Chart 1: US real yields near 15-year high, with bond selloff driven by real yields, not inflation fears



Source: Bloomberg, Vontobel

Chart 2: Interest coverage declining sharply



Source: Bloomberg, Vontobel

A focus on quality and defensiveness to deal with uncertainty

—
Markus Bruhin
Head Managed Solutions,
Vontobel SFA

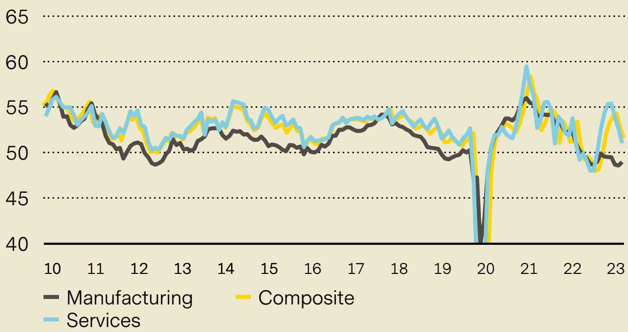
The September effect, which is historically linked to weak stock market returns, lived up to its reputation. Seasonal volatility saw the MSCI All Country World Index dropping more than 4%, taking it to –7% from the July highs. Higher energy prices further complicated matters, spurring speculation about a possible second wave of inflation and the prospect of higher interest rates for an extended period.

Economists continued to highlight factors inhibiting economic growth, such as labor strikes (in the US and Europe), the resumption of student loan repayments (US), diminishing fiscal support (globally) and some high-frequency data, suggesting a slowdown in consumer spending. Another headwind is the Manufacturing Global Purchasing Manager Index (PMI) that remains below the 50-point threshold, the watershed between growth and contraction. The Global PMI increased slightly to 49.1 in September from 49.0 in August (see chart 1). As a rule of thumb, levels of below 45 have coincided with a recession. PMIs have been in the range of 45–50 several times without a recession occurring. However, we expect the data to remain choppy in the near term, because of inflation, improvement in supply chains, high energy prices and high interest rates. On the other hand, we believe the PMI data will improve as inventory destocking and / or normalization runs its course.

A neutral stance
We remain comfortable with our positioning along our long-term strategic view. Macroeconomic dynamics and the resulting central bank decisions will again be the main drivers for equity markets going forward. On this front, we believe that tightening cycles are in their final stages and that a constructive view on stocks makes sense. Regionally, we remain focused on quality, defensiveness and strong earnings predictability, which we find in Switzerland and to a lesser degree in the US. Swiss equities represent an effective hedge in periods of economic stress or, even worse, recessions. This, combined with stable dividends and buybacks yielding a total of more than 5% annually, makes Swiss stocks a very interesting alternative currently (see chart 2). In the US, the disinflation process is proceeding rather smoothly despite the modest reversal seen in August. We saw a sell-off of stocks in September as being in sympathy with bonds. EPS revisions are holding up for now if earnings resilience is indeed confirmed in the Q3 reporting season, it could help markets to stabilize / bounce back from current oversold levels. Sentiment has turned negative and year-end seasonality is typically positive.

Chart 1: Global PMI developments

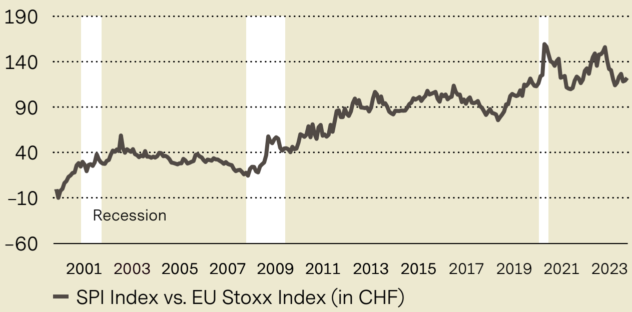
Index



Source: JP Morgan

Chart 2: Swiss equities—an excellent hedge in recessionary times

Relative performance of SPI Index vs. EU Stoxx Index



Source: Bloomberg, Vontobel

Adding fuel to the fire

—
Christoph Windlin
Deputy Head
Investment Management,
Vontobel SFA

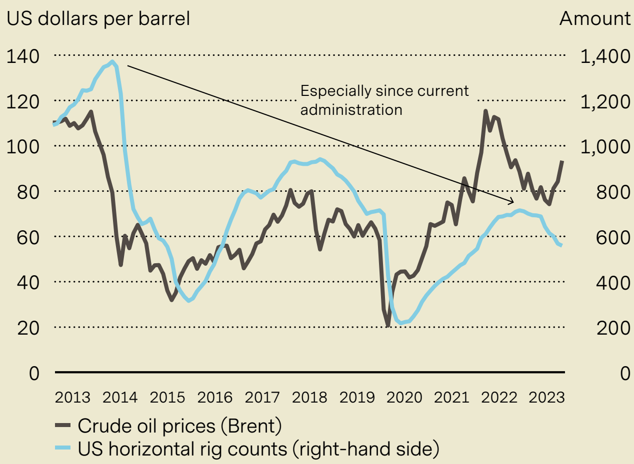
OPEC's decision in early September to extend its cuts in oil output until the end of 2023 caught investors off guard, having expected the curbs to be drawn out for just one more month.

Falling inventories and lack of swing producers fuel the bullish narrative
Concerns about supply shortages—the US Energy Information Administration already held out the prospect of falling inventories in mid-September—drove oil prices well above the USD 90 per barrel mark at the end of the month. Apart from regular inventories, the Strategic Petroleum Reserve (the emergency stockpile of oil maintained by the US Department of Energy) is also flashing warning signs. After the US government repeatedly tapped the reserve, stocks currently stand at just 351 million barrels. Inventories were last this low in the early 1980s. It is unlikely that US shale oil producers will be able to rush to the rescue. Horizontal rig counts, considered a leading indicator of future production, have been on a structural downward trend for years (see chart 1). At the same time, the US has already ramped up its oil production. If the Department of Energy is to be believed, we cannot expect much more oil in 2024.

Preference for gold versus commodities remains
Despite the upside move of the energy complex, we have decided to maintain our underweight view on commodities, while we remain positive on gold. The support for oil stems in particular from the supply side and a readjustment of investor positioning. Speculative positioning on oil moved from significantly underweight to overweight during the summer. As the global economy slows down, support from the demand side seems limited. Given our expectation for interest rates to have neared the peak, this is typically not a beneficial environment for commodities. (see chart 2).

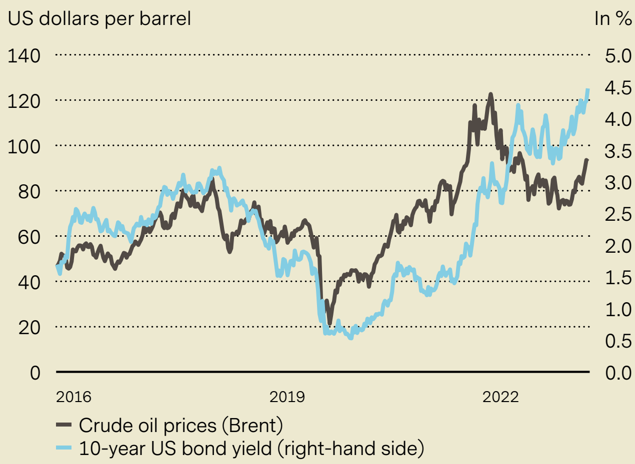
Even though gold has given up some of the gains booked in the first half of the year, we think that the overall environment for the precious metal remains positive. The uncertain macro environment (will there or won't there be a recession), a likely peak in real yields, low speculative positioning and emerging market central bank buying of gold are all factors that can support the price of gold in the months ahead.

Chart 1: Swing producers are likely not coming to the rescue



Source: LSEG, Vontobel

Chart 2: Our key macro convictions argue against commodities



Source: LSEG, Vontobel

Against all odds

—
Dr. Pieter Jansen
Chief Investment Strategist,
Vontobel SFA

Contrary to our expectations of a tougher environment for the US dollar in the second half of the year, the greenback has continued to show widespread strength.

The US Dollar Spot Index has experienced a notable recovery, climbing 6% since hitting a low just shy of 100 in July (see chart 1). The dollar is trading above the 50-day as well as the 200-day moving averages. The 50-day moving average indicates short-to-medium-term trends, while the 200-day moving average reflects long-term trends. The US economy has held up better than expected and consumer spending proved strong in Q3. This robust performance is in sharp contrast to the underwhelming economic data from the Eurozone and widespread worries about the state of China's economy. While US short-term interest rates may have peaked or are close to peaking, the dollar's nature as a counter-cyclical currency means that subdued global growth could continue to support the dollar's strength in the immediate future. However, the dollar is expected to decline further down the line. It is still overvalued relative to its purchasing power parity exchange rate, which has traditionally been a dependable indicator of the currency's future trajectory.

Dollar is not the only safe haven and positioning is stretched

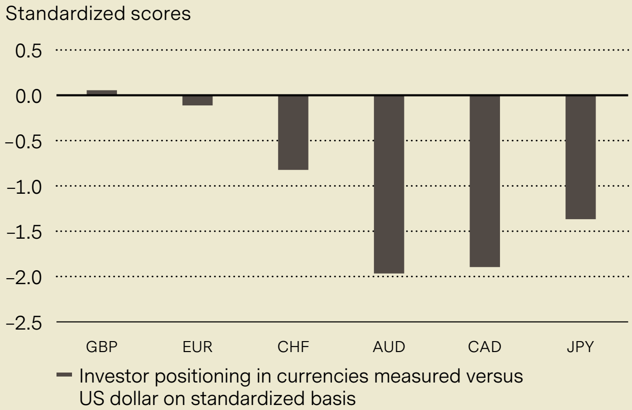
The US dollar is not the only safe haven currency. Periods of rising volatility have also benefited other safe haven currencies, such as the Japanese yen and the Swiss franc. Although the Swiss franc has held its ground versus the US dollar this year, the Japanese yen has weakened substantially. Among the G10 central banks, the Bank of Japan has been alone in leaving monetary policy untouched. Even though the tone is gradually becoming more hawkish, the absence of Japanese monetary tightening has been negative for the yen.

The US dollar would certainly benefit from safe haven flows in case of higher uncertainty. However, investor positioning is already skewed towards the dollar, while speculative investors have been avoiding other currencies that could benefit from global market uncertainty. Chart 2 shows the relative position in foreign currencies versus the US dollar. Once these positions normalize, this could benefit the Swiss franc and Japanese yen, among others.

Chart 1: The dollar strengthens

Source: Bloomberg, Vontobel

Chart 2: Investors are underweight key currencies versus US dollar



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 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	3.3	2.5	2.2
Eurozone	5.3	3.5	0.5	0.5	0.8
USA	5.9	2.1	2.5	2.0	0.9
Japan	2.3	1.1	1.6	1.8	1.0
UK	8.5	4.0	0.4	0.4	0.5
Switzerland	4.3	2.0	0.6	0.8	1.3
Australia	5.3	3.6	2.1	1.6	1.4
China	8.4	3.0	6.3	5.1	4.5

INFLATION	2021	2022	CURRENT[2]	2023 CONSENSUS	2024 CONSENSUS
Global (G20)	3.5	7.3	3.7	5.2	4.2
Eurozone	2.6	8.4	5.2	5.6	2.7
USA	4.7	8.0	3.7	4.1	2.6
Japan	–0.3	2.5	3.2	3.1	1.9
UK	2.6	9.1	6.7	7.5	3.1
Switzerland	0.6	2.9	1.6	2.3	1.5
Australia	2.9	6.6	6.0	5.6	3.3
China	0.9	2.0	0.1	0.6	1.9

KEY INTEREST RATES (IN %)	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR	–0.50	2.00	4.00	3.89	3.47
USD	0.25	4.50	5.50	5.55	4.65
JPY	–0.10	–0.10	–0.10	–0.10	–0.07
GBP	0.25	3.50	5.25	5.55	5.05
CHF	–0.75	1.00	1.75	1.94	1.71
AUD	0.10	3.10	4.10	4.20	3.65
CNY	3.80	3.65	4.35	4.30	4.25

GOVERNMENT BOND YIELDS, 10 YEARS (IN %)	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR (Germany)	–0.2	2.6	2.73	2.43	2.30
USD	1.5	3.9	4.47	3.87	3.60
JPY	0.1	0.4	0.75	0.71	0.75
GBP	1.0	3.7	4.26	4.23	3.75
CHF	–0.1	1.6	1.08	1.13	1.04
AUD	1.7	4.1	4.34	3.96	3.49

FOREIGN EXCHANGE RATES	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
CHF per EUR	1.04	0.99	0.96	0.97	0.99
CHF per USD	0.91	0.94	0.91	0.89	0.89
CHF per 100 JPY	0.79	0.72	0.61	0.64	0.67
CHF per GBP	1.23	1.12	1.11	1.12	1.15
USD per EUR	1.14	1.06	1.06	1.09	1.13
JPY per USD	115.00	130.00	148.00	140.00	132.00
USD per AUD	0.73	0.67	0.64	0.66	0.70
GBP per EUR	0.84	0.88	0.87	0.87	0.87
CNY per USD	6.37	6.91	7.30	7.20	7.00

COMMODITIES	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
Brent crude oil, USD per barrel	79	86	94	85	87
Gold, USD per troy ounce	1,829	1,824	1,927	1,966	2,015
Copper, USD per metric ton	9,720	8,372	8,194	8,400	8,800

1 Latest available quarter
2 Latest available month, G20 data only quarterly
Source: Vontobel, respective statistical offices and central banks; as of September 22, 2023

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