Our View in July

11. July 2023

China's link to the rest of the world

China is an economic heavyweight. If the Chinese economy is humming, it is good news for the rest of the world. But if it is struggling, it is bad news. As this says a lot about the state of demand in the US and Europe.

Is it coming, or is it not, the recession? While economists and analysts are still discussing and sometimes speculating about this question for the US, the recession in the eurozone is already a reality, as the first quarter data have shown.

And even if we look to China, there is little sign of economic confidence. Hopes that the end of strict Covid measures would give the economy a boost have evaporated as quickly as they appeared. Leading indicators pointed upwards only briefly. At the same time, consumer prices in June were unchanged from a year earlier. These are unmistakable signs that the economy in China is struggling.

China's economy has become a good indicator of the state of the global economy. If demand from the US and Europe weakens, the Chinese economy suffers as well. In our view, this situation will get worse before it gets better.

For we are still in the camp of those who expect a significant recession in the US. The credit crunch is slowing the economy and the Federal Reserve is sending clear signals that it will continue to raise interest rates.This mixture speaks for a downturn, which is also a problem for China.

Expectations of this kind have recently flared up again more frequently on the markets. They could be the harbingers that the second half of the year will be more unsettled. In this environment, we remain cautious on equities and prefer liquidity and bonds.

Dr. Felix Brill**, Chief Investment Officer**

Our View on the **Portfolio**

- **Money market investments** benefit from rising interest rates
- Focus on **quality in bonds**
- Yield advantage of **emerging market bonds**

- Low **volatility** is deceptive
- High **valuation** of the US equity market
- Low **credit spreads**

Money Market	●●●●●
Bonds	●●●●○
• Government Bonds	●●●○○
• Corporate Bonds	●●●○○
• USD Bonds	●●●○○
• Emerging Market Bonds	●●●●○
Equities	●○○○○
• Equities Switzerland	●●○○○
• Equities Europe	●●○○○
• Equities USA	●●○○○
• Equities Japan	●●●○○
• Equities Emerging Markets	●●●○○
• Equities World and Themes	●●●○○
Alternative Investments	●●●○○
• Hedge Funds	●●●○○
• Insurance-linked Securities	●●●○○
• Convertible Bonds	●●●○○
• Gold	●●●○○

●●●●● strong overweight; ●●●○○ neutral;
●○○○○ strong underweight

(Base: Mandate CHF balanced)

Our View on the Economy

- Turnover is normalising in the **service sector**
- In the **US**, the recession is postponed

- The **Eurozone** is already in recession; southern European countries are doing better than northern ones
- Despite an improved economic outlook, the global **economic environment** remains difficult

Recession looming

Judging by the interest rate hikes by the central banks, the economy is actually doing quite well. The eurozone as a whole may already be in recession, but it is precisely in the often crisis-ridden southern European countries that things are going better than in the north at the moment, thanks to a booming tourism sector. In the US, the recession is still a long time coming and the economy is still growing, albeit slowly. From this point, the central banks still have the green light to raise interest rates higher. Even the Fed is considering more rate increases. But the higher interest rates go, the more clearly they will hit the economy. This is precisely why we assume that a recession in the US is only a matter of time. Meanwhile, in the eurozone, the southern European countries could also be prone to economic weakness by the end of the year.

Our View on Monetary Policy

- The **Fed** is close to the interest rate peak
- In Switzerland, the inflation rate has fallen below 2%, giving the **SNB** room to manoeuvre

- High core inflation rate forces **ECB** to raise rates higher, we expect three more hikes in 2023
- **Tight monetary policy** increases the risk of stress in the financial system

Central banks keep going on

The central banks do not give the impression that they want to sit back and relax. Even the Fed held out the prospect of another interest rate hike. We now expect it to raise rates by another 25 basis points at the end of July. At the same time, the Fed no longer has an acute inflation problem; inflation rates will probably continue to fall until the end of the year. However, the relatively loose financial conditions despite all the interest rate increases are likely to be a thorn in the Fed's side. This is mainly due to friendly stock markets. And the European Central Bank (ECB) could raise interest rates well into autumn. ECB chief Christine Lagarde has recently been very hawkish. It is now unlikely that the last interest rate hike will be implemented in July. The July increase will probably be followed by two more rate hikes.

Our View on **Government Bonds**

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neutral

- As long as **recession risks** are present, yields at the long end of the yield curve will not rise significantly
- **Record-high forward sales** of US government securities serve as a contra-indicator and speak for falling yields

- **Inflation rates** above target could force ECB to tighten even longer
- Fed could raise rates even more due to robust **labour market**

Two-year yields under the spell of the central banks

The central banks' declared intention to continue to increase interest rates has not been without consequences for yields: they have recently moved higher again. However, falling inflation rates and the unmistakable economic weakness stand in contrast to a rise in yields at the long end of the yield curve. The situation is different in the shorter maturity range. The expected interest rate hikes by the ECB will lead to a higher yield level in the two-year maturity range of European government bonds. This should invert the yield curve even more. An inversion of the yield curve (short-term interest rates are higher than long-term) is a clear verdict by the financial markets that a recession is imminent. Should central banks signal rate cuts in the medium term then government bonds have considerable price potential.

Our View on **Emerging Market Bonds**

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overweight

- **Yield pickup** over government bonds from Europe or the USA
- Large emerging market issuers have become more **economically and financially stable**

- **Defaults of individual countries** can put the whole segment emerging market bonds under pressure
- In the event of **financial market stress**, risk premia rise compared to developed country bonds

Single risk Turkey

The risk premiums of emerging market bonds have remained stable over the past quarters. The fundamental situation has improved noticeably in many emerging markets compared to the 1990s. On the other hand, we consider the situation in Turkey to be critical. Turkey's net foreign exchange reserves have become negative for the first time in 20 years. This means that the much-needed foreign exchange reserves are borrowed from abroad. When Turkey was in the same situation 20 years ago, the country had to seek help from the International Monetary Fund (IMF). With a new central bank president and a new finance minister, the re-elected president Recep Erdogan is trying to win back confidence. However, we consider Turkey to be a single risk, well-diversified emerging market bonds are still attractive.

Our View on **Equities**

strong underweight

- **Smaller** cyclical stocks catch up somewhat
- **Housing construction** in the US still better than feared

- **Economy weakens**, which is not yet reflected in share prices
- **First profit warnings** have implications for the overall market
- **Valuations** continue to rise

Blind in one eye

The equity markets continued their recovery in June, especially in the US, despite increasing risks. Technology stocks continued to rally, fuelled by the theme of artificial intelligence, while cyclical stocks followed suit thanks to sporadic good US data. But contrary to the index move, several companies have published profit warnings for the first half as well as the full year. These companies are spread across a wide range of sectors such as chemicals, consumer goods and life sciences, so these don't appear to be company-specific issues. European companies lament a decline in orders from the previously stable US market. But this should come as little surprise as the Purchasing Managers' Indices (PMI), especially in Europe, continue to point to a slowdown. The hints of more interest rate hikes should also be reflected in the valuations of rate sensitive tech stocks.

Our View on **Equities Emerging Markets**

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neutral

- **Emerging markets** should do better in the event of a price correction the rest of the world
- Depending on the region, **low valuations,** as in China, and **high catch-up potential**
- **High infrastructure investments** should be supportive

- **China** continues to suffer from the consequences of the pandemic
- Stimuli in China not working so far and **investor confidence** has fallen even more
- Dependence on industrialised countries and high **political risks**

The patient China

While many emerging and developed countries have emerged from the immediate aftermath of the Covid pandemic, the Chinese economy continues to suffer. In contrast to China, equities in other emerging markets have held up well. Taiwan's index, for example, benefited from the hype around artificial intelligence. Thus, the MSCI Emerging Markets index ex-China gained almost 10 % so far in 2023, while the MSCI China stands around minus 6 %. Although China's government announced again measures to revive the economy, the market reversed these gains within a month. Disappointment after announced but failed stimuli probably played a role here. This is also reflected in low valuations at the index level, which do not seem to arouse increased demand among investors. The situation also has an impact on stocks of European companies which are dependent on exports to China.

Our View on **Gold**

neutral

- Increased stress in the banking sector confirms **safe haven status**
- Interest rate cut **speculation increases attractiveness of interest-free investments**
- **Strong central bank demand** is supportive

- **Outflows** from listed funds and reduction of speculative positions
- **Economic soft landing** would favour riskier investments

Waiting for lower interest rates

The gold price was unable to reach a new all-time high. This is because the risks driving gold prices, such as stress in the banking sector or the dispute over the debt ceiling in the US, declined. Accordingly, listed gold funds recently recorded outflows, while at the same time speculators on the futures markets scaled back their euphoria. Interest rate cuts are also off the table for the time being, which is why the potential for short-term gains appears limited. Nevertheless, investors have recorded a strong first half-year with gold. Gold has also held up better than its precious metal counterparts such as silver, platinum and palladium. This reinforces our view that gold stabilises the portfolio, especially in difficult market phases, thanks to a low demand from the manufacturing industry and the independence from the economic cycle.

Our View on Currencies

- The **euro** could surprise
- The **British pound** benefits from higher key interest rates and the lower rate differential against the dollar

- Emerging market currency appreciation remains **limited amid geopolitical risks**
- **Turkish lira** remains under the spell of politics, despite a big rate hike

The three winning currencies

The dollar has been a strong currency for quite some time. The same is true for the Swiss franc. But now, in a global comparison, the euro also belongs to the club of strong currencies: Not against the dollar and the franc, but against the rest of the world. The Swedish and Norwegian krona and the Australian and New Zealand dollars have suffered significant losses against the European single currency in some places in recent years. The same applies to emerging market currencies. As long as geopolitical uncertainties persist and there is no sustained global economic upswing, the dollar, the franc and the euro will remain winning currencies. Although the euro is lagging behind within this triumvirate.

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