Monthly CIO Letter

16 December 2022

The improvement in financial market sentiment has persisted in recent weeks. The crucial question remains how inflation will develop, as this will also shape central bank policy and ultimately expectations of the landing for the economy – hard or soft? We are sticking with the equity overweight stance we initiated back in October and switching our focus to China.

Christoph Boner
Chief Investment Officer

Highlights

- How inflation develops will remain crucial in 2023 too.
- Expectations of a further decline in inflation has fuelled hope and brought about an improvement in market sentiment.
- We are retaining our equity overweighting and close our underweight stance in the emerging markets by increasing exposure to Chinese equities.

Asset Allocation

Asset Classes	Change	– –	–	=	+	+ +
Liquidity	→				●	
Bonds	→	●				
Reference Currency	→	●				
World	→	●				
Emerging Markets	→					●
Convertible Bonds	→				●	
Equities	→				●	
Switzerland	→				●	
Europe	→			●		
US	↓			●		
Pacific	→			●		
Emerging Markets	↑			●		
Alternative Assets						
Gold	→				●	
Crypto Assets	→				●	
Currencies						
CHF	→			●		
EUR	→			●		
USD	→			●		

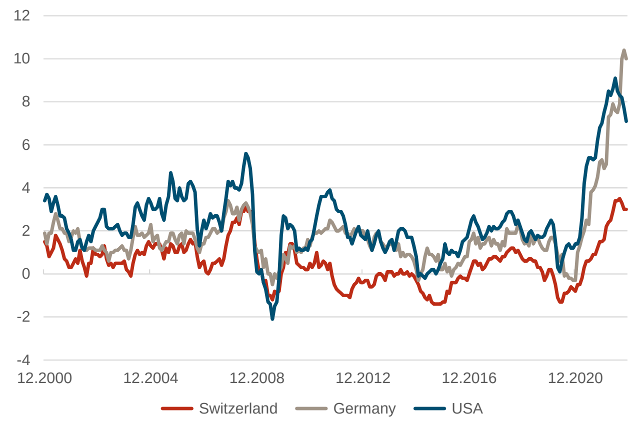
Change: compared to previous month, **Positioning**: -- strongly underweighted | - underweighted | = neutral | + overweighted | ++ strongly overweighted

Asset Allocation

The improvement in global financial market sentiment has persisted in recent weeks. When measured in USD, the global equity market has risen by more than 13% since the end of September. Thanks to less upward pressure on interest rates and a narrowing of credit spreads, global bond markets (IG) have also recorded sharp counter-movements, equivalent to a rise of around 5% when hedged in USD.

The development of inflation – and by extension central bank policy – has been the dominant financial market theme of 2022. Higher interest rates and fears of a further cooling of the economy have weighed on security prices in multiple asset classes.

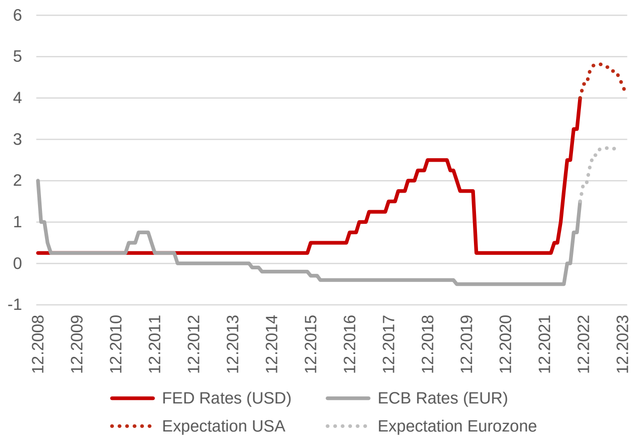
Theme no. 1 in 2022: Inflation (in %)



In 2023 too, the crucial question will be how much longer inflationary pressure will persist, and how strongly central banks will attempt to counteract it by raising interest rates. The expectations of market participants cover quite a spectrum. At one end of the scale, there are the more optimistic observers who expect inflationary pressure to recede rapidly. They can put forward various arguments to support their case – base effects, a normalisation of supply chains, and falling input prices, particularly for energy. At the other end of the spectrum can be found the more pessimistic economists, whose expectations range from persistently high rates of inflation to a full-blown inflationary spiral due to the worrying impact of second-round effects.

In our view, concerns over excessive aggression on the part of central banks are probably not misplaced. However, the same fears also look exaggerated, as central banks – with their overriding priority of managing inflationary expectations – inevitably adopt an uncompromising tone in their communications. For one thing, central banks will permit relatively high rates of inflation in the medium term; in addition, just like the financial markets they are aware that the risk of going too far is very real. This will be factored into considerations when deciding on the direction of monetary policy going forward, and the risk of an excessively hard landing will be reduced as a result.

Theme for 2023: Central banks, key interest rates, and expectations



In keeping with this belief that the market still has an overly negative view of inflationary and interest rate developments, we are leaving the equity allocation unchanged at overweight for the start of 2023. The allocation for a balanced profile is 52%. In a change to the existing regional allocation, we are taking profits on US equities and reallocating the resulting funds to China. The attractive valuation and growth outlook of China, and the softening of the zero-COVID policy – with the likelihood of a resurgence of economic pragmatism replacing the previously feared continuation of a dogmatic stance – opens up the prospect of significant recovery potential in the Asian region too.

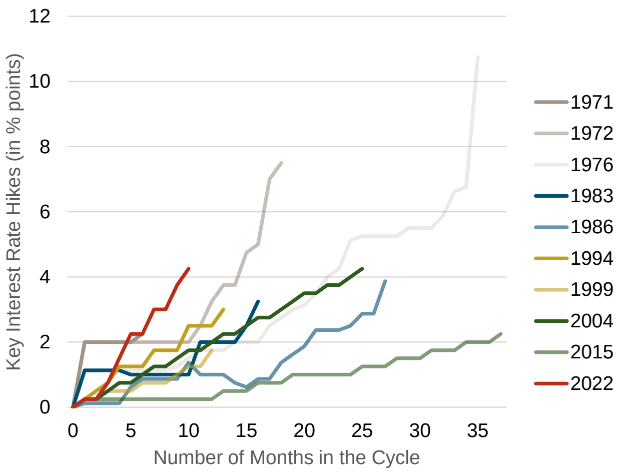
We are keeping the bond allocation at the lower end of the possible bandwidth. A balanced strategy has a bond allocation of 35%, whereby we are deliberately including hard currency bonds from emerging countries due to the higher yields they offer.

The use of diversifying asset classes should also be an additional element in the asset allocation process, and we are therefore holding gold in particular in the portfolios. We are also holding some crypto investments.

Bonds

As explained in the CIO letter of November, we take the view that inflation will have peaked by the second quarter of 2023 at the latest. Given this assumption, it is only reasonable to infer a less hawkish stance by central banks. After all, when looking at historical rate-hiking cycles, it is clear that key rates have never been increased so sharply and at such a tempo. This approach has probably increased the risk of a hard landing due to a hefty slump in demand. But the fact of the matter is that the indications of inflation-driving, second-round effects are few and far between, and consumer spending is proving to be extremely robust. Even if a number of stimulating effects will fade away over the coming months, we still presume a soft landing is possible.

Historic rate-hiking cycles: magnitude and speed



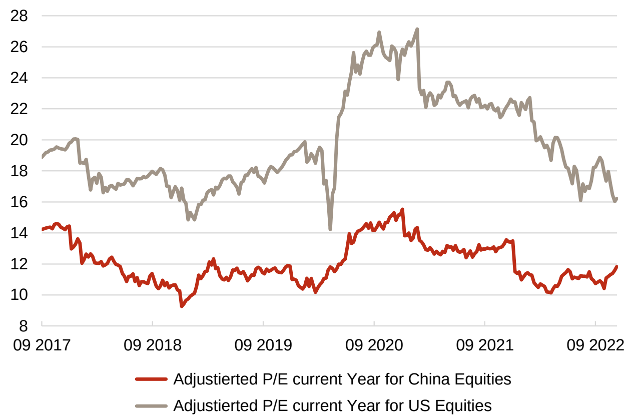
The expected (market-implied) peaks for key interest rates have stabilised in recent weeks, to the point where we believe they are now broadly in line with the likely peak level. Given the prevailing uncertainty, however, volatility will remain high.

Equities

The frequently flagged-up discrepancy between the broadly negative macroeconomic outlook and the persistently robust situation at the microeconomic level remains evident. We believe the macroeconomic view is dominating the current narrative, with insufficient attention being paid to the enduring solidity of company figures. Although negative surprises are bound to occur given that the outlook has undoubtedly taken a turn for the worse, the development of price/earnings ratios – namely a sharp contraction over the last few months – provides further room for a counter-movement. A slightly brighter picture, e.g. due to a more dovish tone in the communications of central banks, could help markets to bounce back simply by removing some of the current risk aversion out of equity prices.

We are accordingly maintaining our overweight stance in equities, while shifting it from the US to the Chinese stock market. Current valuation levels and a return to economic pragmatism by the Chinese authorities – with the repeal of the most rigorous COVID measures being an obvious example – create healthy parameters for the positive development of Chinese equities.

Development of price/earnings ratio of Chinese equities



Alternative Assets

Alternative investments serve to provide additional diversification in a portfolio context and thereby help to improve the risk/return ratio. Due to risk considerations we are continuing to hold investments in both gold and cryptocurrencies.

Currencies

Due to modified expectations of key interest rate developments stateside, the US dollar has lost significant ground. We are leaving our foreign currency weightings unchanged.

Editorial Investment Center

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Appendix

Economy and Markets

GDP (E: Consensus)

	2021	2022E
USA	5,9%	1,8%
EU	5,4%	3,3%
Switzerland	4,3%	2,1%

Inflation (E: Consensus)

	2021	2022E
USA	4,7%	8,1%
EU	2,6%	8,5%
Switzerland	0,6%	2,9%

Central Bank Rates

	13.12.2022	Outlook
USA	4,0%	4,75%
EU	1,5%	2,50%
Switzerland	0,0%	1,75%

Capital Market Rates (10 Years)

	13.12.2022	Outlook
USA	3,5%	3.50% – 4.00%
Germany	1,9%	1.85% – 2.35%
Switzerland	1,2%	0.85% – 1.35%

Foreign Exchanges

	13.12.2022	Outlook
EUR/CHF	0,987	0.95 – 1.00
USD/CHF	0,928	0.94 – 0.99
EUR/USD	1,063	0.99 – 1.05

Raw Materials and Alternatives

	13.12.2022	Outlook
Gold (USD/Ounce)	1810,8	1725 – 1825
Oil (USD/Brent)	80,7	80 – 105
Bitcoin USD	17.762	16'000 – 20'000

Equity Markets

	P/E ø 5J.	P/E 2023	Div. Yield	Outlook
World	18,1x	15,4x	2,2%	slightly up
USA	19,8x	17,2x	1,7%	slightly up
Europe	15,7x	12,2x	3,3%	slightly up
Switzerland	18,6x	16,5x	2,9%	slightly up
Emerging Markets	13,4x	11,4x	3,2%	slightly up

Markets in Local Currencies

Equity Markets

	QTD	YTD
World	14,6%	-14,2%
USA	12,5%	-14,4%
Europe	14,5%	-6,2%
Switzerland	7,9%	-13,6%
Emerging Markets	10,5%	-19,3%

Government Bond Yield (10 Years)

	13.12.2022	31.12.2021
USA	3,50%	1,51%
Germany	1,93%	-0,18%
Switzerland	1,18%	-0,14%

Raw Materials and Alternatives

	QTD	YTD
Gold (USD/Ounce)	9,0%	-1,0%
Oil (USD/Brent)	-4,7%	82,5%
Bitcoin USD	-8,6%	-61,7%

Foreign Exchanges

	QTD	YTD
EUR/CHF	2,1%	-4,8%
USD/CHF	-5,9%	1,7%
EUR/USD	8,5%	-6,5%

Data as of 13 December 2022, QTD: Performance since Beginning of Quarter, YTD: Performance since Beginning of Year