Monthly CIO Letter

26 June 2023

Revised interest rate expectations again supported markets in the second quarter of 2023. The current (excessively) optimistic assessment of the future course of interest rates has given rise to the potential for negative surprises. We are taking profits on US equities and reducing the equity allocation.

Christoph Boner
Chief Investment Officer

Highlights

- Equity markets in particular have been in an upbeat mood in recent weeks on more concrete forecasts that the current interest rate cycle might have peaked.
- With inflation still running at a high level, coupled with tight labour markets and persistently strong demand across the economy, these interest rate expectations could nevertheless be dashed.
- We are reducing our US equity exposure and selling positions in the tech sector.

Asset Allocation

Asset Classes	Change	– –	–	=	+	+ +
Liquidity	↑				●	
Bonds	→		●			
Reference Currency	→	●				
World	→		●			
Emerging Markets	→					●
Convertible Bonds	→				●	
Equities	↓		●			
Switzerland	→			●		
Europe	→			●		
USA	↓		●			
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

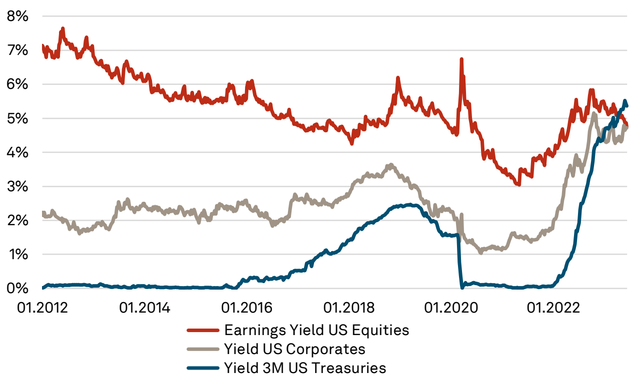
Despite forecasts of an economic slowdown and the start of a slowdown or even a recession, financial markets will post a decent or even good performance for the first six months of 2023.

While global equity markets advanced by over 10%, bond markets likewise made gains. Developments in recent weeks in particular are attributable to a significant shift in interest rate expectations. Given the problems that have arisen within the financial system, the market has revised its expectations on the future course of interest rates. The market now expects initial rate cuts in the US later this year, while the first cuts in Europe are anticipated in the first quarter of 2024.

We view these expectations on future interest rates as too optimistic, however. First, inflation remains above the targets set by central banks; second, the labour market continues to look robust and demand across the economy as a whole is showing no let-up. Other than at the time of an external shock, central banks have never before cut interest rates in a situation such as this one.

Given the excessively optimistic view of future interest rates, coupled with the ongoing need for an economic slowdown via a squeeze on demand, this gives rise to a potential setback for riskier investments – even though the fundamental picture remains positive at the level of corporate results.

Relative attractiveness of various asset classes



Analysis of the relative attractiveness of various asset classes also shows that the current yield on corporate bonds and sovereigns is now above the earnings yield for the US equity market following the rapid rate hikes of the past 15 months. Equities have therefore lost much of their appeal.

Following the strong showing of recent weeks, we are taking profits on US technology stocks by selling positions; this consequently reduces our equity allocation, which now stands at 48% for a balanced equity profile.

The weighting of fixed income securities is unchanged and the bond allocation for a balanced mandate amounts to 40%. We are also continuing to hold USD-denominated emerging market bonds in view of their persistently attractive return characteristics. In addition, we have added a structure that enables us to benefit from a normalisation of the USD yield curve. The credit quality of the overall bond quota remains above average, while the duration is shorter than that of the market.

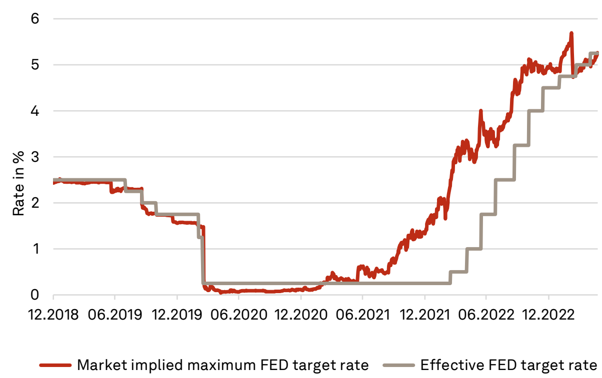
For diversification purposes we are continuing to hold gold and crypto investments.

Bonds

The Fed's mid-June decision to leave key interest rates untouched for now had been expected by market participants. The ECB's decision to hike the key European rates further was likewise in line with what the market had been anticipating.

Uncertainty in terms of expectations for the next rate moves has increased, however – especially against the backdrop of comments from Fed Chair Jerome Powell. Nevertheless, the general feeling is that the rate hike cycle is likely to have peaked and that rate cuts can be expected in the more foreseeable future.

Interest rate expectations and US key rates



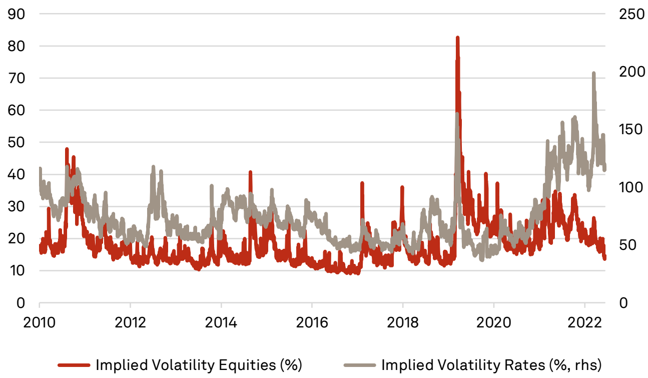
We think market expectations are too optimistic given persistently robust demand and a labour market through which second-round effects still threaten to torpedo the downward trend of inflation. In the current environment, we think central banks will be too mindful of their targets and the focus on the battle against inflation to risk stoking up the overall economy through interest rate cuts. The ECB in particular – and to a lesser extent the US Fed, too – will pay less attention to the economic environment, and in particular the development of the capital markets, than market participants currently wish and hope for.

Consequently, nor is this the time for an increase in the average maturity on bond portfolios – all the more so given that sharply inverted yield curves in some cases already favour maturities at the short end.

Equities

Comments issued by companies during the current reporting season suggest the fundamental picture for equities remains intact. However, the positive development of share prices is heavily driven by the change in expectations in the interest rate markets as set out above.

Market-implied volatilities of equities and bonds



In general, the equity market is currently in a relatively relaxed mood. By definition in a bull market – gains of over 20% since the most recent low – and with currently low market-implied volatility levels, other indicators are also showing that buyers currently dominate developments.

Drill down a bit further, however, and it seems the positive market development of recent weeks has been heavily driven by specific sectors and segments. After stripping out the big five tech stocks, for example, the US equity market is actually up only 3% since the start of the year; thanks to tech stocks, however, the overall market has gained as much as 13%.

The excellent performance shown by these stocks – led by NVIDIA – may well continue. The exuberance is partly explained and rationalised by the AI narrative as well as the associated economic and social potential.

Even so, we think time has come to take profits on these positions; we are therefore reducing the equity allocation by selling positions concerned. For now, the resulting gains will be retained as liquidity in the relevant reference currency.

Alternative Assets

Alternative assets serve to achieve further diversification in a portfolio context. For this reason we continue to hold gold as well as a position in crypto assets.

Currencies

Whereas the EUR/CHF currency pair has trended sideways in recent weeks, USD has lost a bit of ground again following an interim bout of stabilisation. With our scaling back of US equities, we are likewise reducing the USD component; however, we have decided not to hedge the remaining USD or EUR exposures.

Editorial Investment Center

Christoph Boner, CIO (BOC), +41 44 205 12 16, bonerchristoph@pbihag.ch

Patrick Frei, CFA (FRP), +41 44 205 13 32, freipatrick@pbihag.ch

Annex

Economy and Markets

GDP (E: Consensus)

	2022	2023E
USA	2.1%	1.2%
EU	3.6%	0.7%
Switzerland	2.1%	0.8%

Inflation (E: Consensus)

	2022	2023E
USA	8.0%	4.1%
EU	8.4%	5.5%
Switzerland	2.9%	2.4%

Central Bank Rates (higher)

	21.06.2023	Consensus
USA FED	5.3%	5.25%
EUR ECB	3.5%	3.75%
CHF SNB	1.5%	

Government Bonds (10 Years)

	21.06.2023	Outlook
USA	3.7%	3.60% – 3.85%
Germany	2.4%	2.35% – 2.60%
Switzerland	1.0%	0.85% – 1.10%

Foreign Exchanges

	21.06.2023	Outlook
EUR/CHF	0.971	0.95 – 1.00
USD/CHF	0.901	0.88 – 0.93
EUR/USD	1.077	1.03 – 1.08

Raw Materials and Alternatives

	21.06.2023	Outlook
Gold (USD/Ounce)	1'933	1'900 – 2'000
Oil (USD/Brent)	77.1	70 – 80
Bitcoin USD	29'985	25'000 – 31'000

Equity Markets

	P/E ø 5J.	P/E 2024	Div. Yield	Outlook
World	18.7x	16.3x	2.1%	slighlty down
USA	20.3x	18.0x	1.6%	slighlty down
Europe	15.9x	11.9x	3.5%	sideways
Switzerland	19.6x	16.7x	3.0%	sideways
Emerging Markets	13.6x	11.3x	3.0%	sideways

Markets in Local Currencies

Equity Markets

	QTD	YTD
World	5.5%	13.9%
USA	6.6%	14.6%
Europe	1.6%	10.3%
Switzerland	1.1%	7.1%
Emerging Markets	2.3%	6.4%

Government Bond Yield (10 Years)

	21.06.2023	30.12.2022
USA	3.72%	3.87%
Germany	2.44%	-0.18%
Switzerland	0.98%	1.62%

Raw Materials and Alternatives

	QTD	YTD
Gold (USD/Ounce)	-1.9%	6.0%
Oil (USD/Brent)	-4.3%	-11.7%
Bitcoin USD	5.6%	80.9%

Foreign Exchanges

	QTD	YTD
EUR/CHF	-1.1%	-0.8%
USD/CHF	-2.4%	-3.4%
EUR/USD	1.4%	2.6%

Data as of 21 June 2023, QTD: Performance since Beginning of Quarter, YTD: Performance since Beginning of Year