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Monthly CIO Letter

27 November 2023

The most recent figures on the development of inflation are strengthening expectations of an end to interest rate rises. The extent to which these expectations are being driven by mere hopes will become apparent over the next few months. Current valuations can only be justified on the basis of higher macroeconomic growth or lower interest rates.

Christoph Boner
Chief Investment Officer

Highlights

– Further declines in inflation figures are reducing the pressure on central banks for the time being.

– The US economy continues to expand beyond its potential growth rate, which weakens the prospect of interest rate cuts any time soon.

– A cautious positioning with a short duration and an underweight equity allocation remains the order of the day. An increase in earnings growth would be required to maintain current valuation levels.

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

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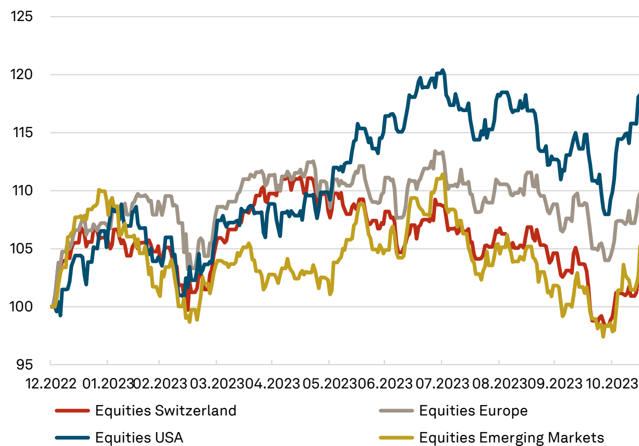
Asset Allocation

After recording significant falls in October, equity markets embarked on a sharp countermovement in November. Taking global equity indices (in USD) as the measurement basis, equity prices have rebounded more than 8% from this setback, taking their positive performance for the year to date to more than 16%.

Equity markets: 2023 performance



The driver of this strong countermovement – in addition to an oversold market dominated by risk aversion following the escalation of events in the Middle East – was the abrupt decline in bond yields. For example, after temporarily flirting with the 5% mark, the yields on 10-year US government bonds then fell back to below 4.5%.

This decline in yields was driven first and foremost by falling inflation figures. While inflation remains above the desired target bandwidth, its further decline has buoyed hopes of an end to the current rate-hiking cycle – indeed, the market is now expecting rates to be cut no later than the second quarter of 2024, if not in the first quarter. The possibility of upward inflationary pressure returning is largely being disregarded, as is the fact that the US economy continues to expand above its potential growth rate. When combined with tight labour markets, this could provide fertile ground for a renewed rise in inflation.

We are leaving the equity quota for a mandate with the "Balanced" profile at 48% for the time being, i.e. equivalent to a slight underweighting, with the only change being regional diversification away from Swiss equities towards the Pacific region – this in anticipation of our newly defined strategic orientation for 2024.

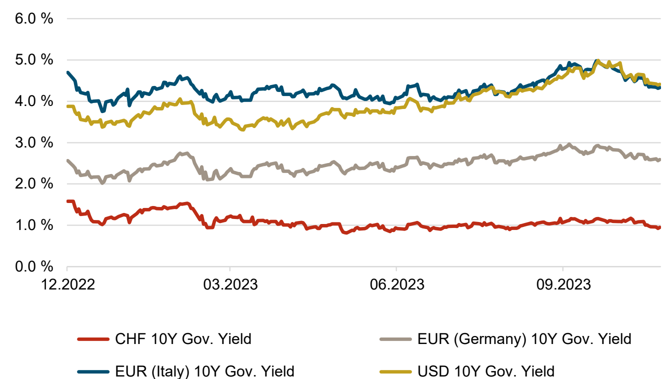
The allocation to fixed-income securities is likewise being slightly pared back in light of the new strategic orientation. Given the broader strategic positioning within the bond segment going forward, an initial step will be to reduce the holding of investment-grade instruments for the relevant reference currencies; the resulting funds will be channelled into liquidity. The fixed-income quota for the above-mentioned risk profile therefore now amounts to 36%, with the exposure to emerging market bonds remaining unchanged. The credit quality of the overall bond quota remains above average, while the duration is shorter than that of the market as a whole. We are also retaining our positioning in anticipation of a further normalisation of the USD yield curve – a stance that has already made a positive contribution to the investment result in recent weeks.

Gold and crypto investments remain part of the allocation, with the "new currencies" in particular having made a strongly positive contribution to the performance of the portfolio.

Bonds

While the communications and passive stance of various central banks have had a calming effect at the short end and brought about a relative stabilization of key interest rate expectations, volatility at the longer end of the yield curve has remained high against a backdrop of uncertainty over economic development. For example, the yield on 10-year US Treasuries rose to 5% – the highest level recorded since July 2007 – before falling back below 4.5% over the last few days.

Development of 10-year yields on government bonds



With the publication of the most recent CPI figures, the market's expectations of an end to the rate-hiking cycle have solidified. Even though the Fed is still reserving the right to increase the federal funds rate further, the bond market is taking the opposite view and expects the first cuts to key rates to come as early as the end of Q1 2024. A similar situation is apparent in Europe.

Both equity and bond markets are drawing a considerable amount of hope from these expectations, which explains the strong price rises of both these asset classes in recent weeks. However, it remains unclear why the reversal in monetary policy should come so early, as neither inflationary developments nor the current labour market situation make rate cuts look like a wise move as things stand. An obvious reason for a switch to more accommodating monetary policy would be an excessive economic slowdown – but such a development would

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obviously put pressure on markets generally as an initial response.

The premiums payable on higher-risk bonds should currently be viewed as too low. The additional yield that these instruments offer does not compensate investors for the generally elevated risk of default. What's more, there is no scope in monetary terms – and little fiscal scope either – for bailing out individual borrowers, let alone the market as a whole. While the assessments of the creditworthiness of large companies by the key rating agencies continue to paint a stable picture, the number of defaults and bankruptcies among smaller companies is already rising sharply. A cautious credit positioning remains the order of the day. Moreover, we are keeping the duration decidedly short as the yield curve continues to normalise.

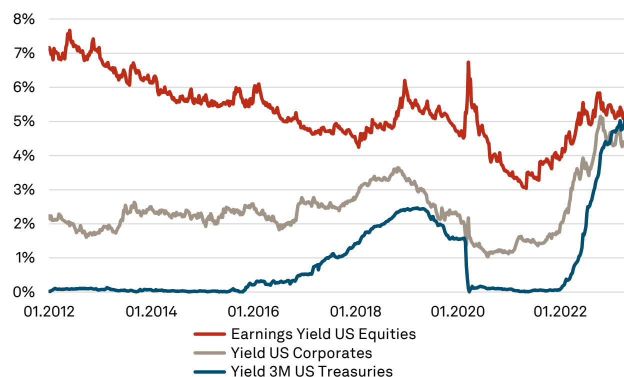
Equities

Equity markets continue to be driven by interest rate developments and the corresponding expectations. With inflationary pressure expected to ease, equities have responded with price rises across the board. Quite aside from the fact that lower (expected) interest rate levels are conducive to price rises, the resulting economic stimulus via higher growth should also feed through positively into corporate earnings figures. On the other hand, the risk of an abrupt slowdown of the economy and the pressure of higher real interest rates are also rising with every day that key interest rates remain unchanged. The current stance adopted by central banks – watch and wait – inevitably runs the risk of excessive contraction, with the knock-on effect of a "hard landing".

The current reporting season in the US, which is now drawing to a close, shows that the great majority of companies have hit their earnings targets. However, a more cautious outlook is also evident for the next quarters. Higher growth is necessary, however, to justify current valuations in an environment of elevated interest rates. But this growth is precisely what central banks are looking to push down below the level of potential growth through higher interest rates – only then can they achieve their inflation targets.

Thus it can be concluded that the current level of earnings growth is insufficient for equity markets to sustain further upward movement.

Returns on various asset classes



The current imbalance between the returns achievable on equities and bonds therefore remains in place. While such a situation can obviously persist, a decline in equity prices and/or lower interest rates are what constitute the likely pathway to equilibrium in the medium term. The "higher growth" factor is out of the picture for the time being.

Alternative Assets

Alternative assets such as gold and crypto investments bring diversification to a portfolio. Moreover, it is now clear that the diversification effect of cryptocurrencies in particular is greater than might have been suspected last year. Given the prevailing global tensions, gold can be expected to contribute further to the stabilisation of the portfolio, despite higher real interest rates.

Currencies

We are leaving our foreign currency allocations in USD and EUR unchanged for the time being, consciously diversifying the former currency risk with the above-mentioned position in gold.

Editorial Investment Center

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Appendix

Economic and market development

GDP (E: Consensus)

	2022	2023E
USA	1.9%	2.3%
EU	3.5%	0.6%
Switzerland	2.7%	0.8%

Inflation (E: Consensus)

	2022	2023E
USA	8.0%	4.2%
EU	8.4%	5.6%
Switzerland	2.9%	2.2%

Central Bank Rates (higher)

	21.11.2023	Consensus
USA FED	5.5%	5.50%
EUR ECB	4.0%	4.00%
CHF SNB	1.8%	

Government Bonds (10 Years)

	21.11.2023	Outlook
USA	4.39%	4.30% – 4.60%
Germany	2.57%	2.50% – 2.75%
Switzerland	0.96%	0.90% – 1.05%

Foreign Exchanges

	21.11.2023	Outlook
EUR/CHF	0.964	0.93 – 0.97
USD/CHF	0.884	0.87 – 0.92
EUR/USD	1.091	1.07 – 1.10

Raw Materials and Alternatives

	21.11.2023	Outlook
Gold (USD/Ounce)	1'998	1'950 – 2'050
Oil (USD/Brent)	82.5	77 – 85
Bitcoin USD	36'841	33'000 – 38'000

Equity Markets

	P/E ø 5J.	P/E 2024	Div. Yield	Outlook
World	18.8x	16.7x	2.0%	sideways
USA	20.6x	18.7x	1.5%	sideways
Europe	15.8x	12.1x	3.4%	sideways
Switzerland	19.7x	16.8x	3.1%	sideways
Emerging Markets	13.7x	11.4x	2.9%	sideways

Markets in Local Currencies

Equity Markets

	QTD	YTD
World	5.4%	17.6%
USA	6.1%	19.9%
Europe	1.5%	10.9%
Switzerland	-1.5%	3.1%
Emerging Markets	3.9%	6.1%

Government Bond Yield (10 Year)

	21.11.2023	30.12.2022
USA	4.39%	3.87%
Germany	2.57%	-0.18%
Switzerland	0.96%	1.62%

Raw Materials and Alternatives

	QTD	YTD
Gold (USD/Ounce)	8.1%	9.6%
Oil (USD/Brent)	-8.2%	0.4%
Bitcoin USD	36.1%	122.2%

Foreign Exchanges

	QTD	YTD
EUR/CHF	-0.4%	-2.6%
USD/CHF	-3.5%	-4.4%
EUR/USD	3.2%	1.9%

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