Monthly CIO Letter

22 January 2024

The timing of the first interest rate cuts remains of paramount importance as 2024 gets under way. The market is optimistic in its expectation that the first cuts will come in March. Quite aside from the fact that these hopes could be disappointed, markets could come under pressure from a number of other risk areas, above all the geopolitical sphere. We remain cautiously positioned.

Christoph Boner
Chief Investment Officer

Highlights

- After finishing 2023 with two strong monthly performances, the equity market is currently stuck in a directionless mode.
- Expectations of impending interest rate cuts have had to be recalibrated over the last few days in response to various macroeconomic indicators.
- Other exogenous and above all geopolitical factors may also impact on markets negatively over the coming weeks and months.

Asset Allocation

Asset Classes	Change	– –	–	=	+	+ +
Liquidity	⬆					●
Bonds	➡		●			
Reference Currency	➡		●			
World / Themes	➡		●			
Emerging Markets	➡			●		
Convertible Bonds	➡				●	
High-yield Bonds	➡	●				
Equities	⬇		●			
Switzerland	⬇				●	
Europe	⬇				●	
US	➡		●			
Pacific	➡			●		
Emerging Markets	⬇			●		
Themes	➡	●				
Alternative Assets						
Gold	➡			●		
Crypto Assets	➡				●	
Other	➡	●				
Currencies						
CHF	➡			●		
EUR	➡				●	
USD	➡				●	

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

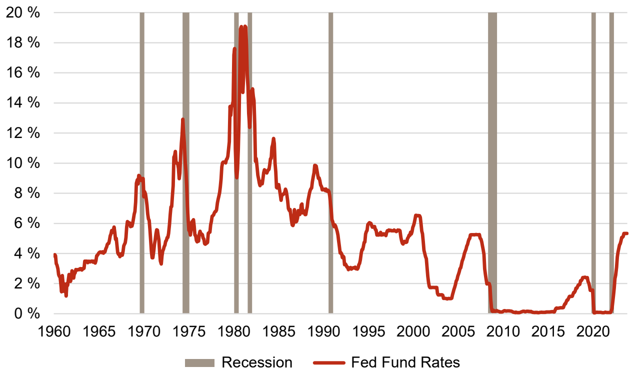
Asset Allocation
From the investor's perspective, 2023 was a good one. While the global equity market recorded a gain of more than 20% (in USD) last year, ranking it among the three best years of the last three decades, the bond market likewise recorded an above-average value gain of just under 6%.

Declining rates of inflation in the fall had already fuelled hopes among market participants that an end to the rate-hiking cycle was in sight, but the corresponding confirmation from the Fed in December lit the touchpaper under both equity and bond markets.

Ongoing hopes of a soft landing also fit with this picture. While past experience may provide grounds for scepticism, this constellation – persistently robust macroeconomic demand while inflation has in recent months been driven partly by strong supply-side factors – would ensure a soft landing and avert a deep recession.

At the same time, however, the prevailing geopolitical risks are being largely ignored, while the various impending elections over the course of 2024 – more than half the world's population is set to head to the polls this year – are likely to leave some sort of mark on the financial markets.

Key interest rates and recessions



Given this positive general mood and the not inconsiderable risk of the market being disappointed – whether due to later-than-expected interest rate cuts, a hard landing, or political upheavals – we are reducing the equity quota to 42% for a balanced profile after taking profits in December. This compares to a strategic equity quota of 45%. The reduction is being effected above all at the cost of European equities.

The allocation to interest-bearing securities will remain unchanged for the time being. With a short duration and high credit quality, this side of the portfolio remains both robustly and defensively positioned. The fixed-income quota for the above-mentioned risk profile therefore now amounts to 36%, with exposure to emerging market bonds remaining unchanged. We also remain positioned in anticipation of a further normalisation of the USD yield curve. Even though the high-yield segment will form part of the strategic allocation going forward, we are still staying away from securities in this riskier bond segment – mainly because the credit spreads for low-quality bonds are much too narrow.

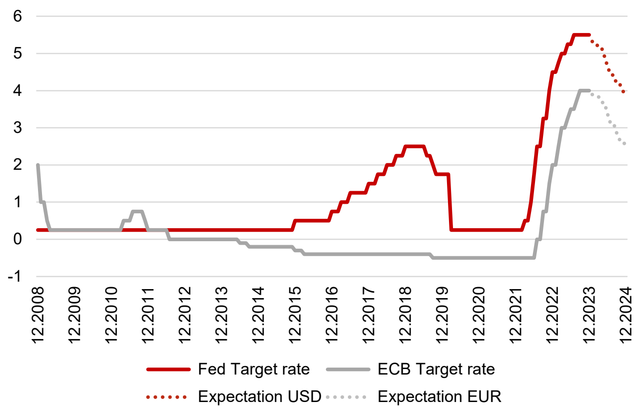
Gold and crypto investments continue to form part of the allocation. While the former brings diversification and hedging qualities to a portfolio, particularly against a background of geopolitical turmoil, the admission of crypto ETFs for trading in the US demonstrates the ongoing institutionalisation of this relatively new currency type. Even after an extremely strong 2023, this factor should be positive for the development of these investments in the future too.

Bonds
As already discussed in our CIO Letter of November, a discrepancy emerged in the autumn 2023 between the statements of central banks on the one hand – in a nutshell, "higher for longer" – and the expectations of market participants on the other, namely interest rates falling in the foreseeable future.

Taking an opposing stance to central bank utterances is generally an unwise course of action, but in this case the first round went the way of investors, as the Fed duly announced in December that the first rate cuts would indeed come in 2024. Accordingly, investments racked up impressive gains across the board.

However, this belated shift on the part of central banks has had the effect of further strengthening market participants' expectations where impending rate cuts are concerned. Whereas in December the market was expecting three or four rate cuts, with the first anticipated in June 2024, it is now expecting six or seven cuts starting as early as March 2024 and taking the federal funds rate to below 4% by the year-end. In other words, the potential for a negative surprise still remains – albeit at higher price levels.

Key interest rates and market-implied expectations



Quite aside from the fact that this expectation is extremely optimistic and implies possible disappointments, various macro indicators have forced a recalibration of interest rate expectations at the start of the new year. Not only are inflation figures still higher than the levels acceptable to central banks, but persistently tight labour markets continue to pose a risk of second-round effects. In our view, having been taken by surprise by the rise in inflation over the last two years, central banks are unlikely to be letting their guard down when it comes to taming this phenomenon. Overdoing it remains the key risk, and the scope for rate cuts is clearly far below the extent reflected in current expectations.

Moreover, the possibility of exogenous shocks cannot be dismissed. These could prompt central banks to initiate premature rate cuts in order to achieve a stabilising effect. Overall, this risk is by no means negligible over the next few months. In addition to the fact that geopolitical risks are being largely disregarded at the moment, impending elections all around the world – including in Europe, India and the US – harbour clear potential for surprises.

Given this muted macroeconomic backdrop, the credit spreads of riskier bonds also remain too narrow. A cautious credit positioning remains the order of the day, and the duration is being kept at its shorter current level.

Equities

The positive scenario of impending interest rate cuts and a soft landing of the economy has provided considerable fuel for equity markets over the last few weeks. But the risks are not difficult to discern – delayed or lower-than-expected rate cuts, a hard landing with recessionary elements, and exogenous shocks.

Although equity valuations remain fair when measured on the basis of price-earnings ratios, the current situation is in a state of disequilibrium: the prevailing level of interest rates and current equity market levels require higher earnings growth – such as through productivity increases on the back of technological progress – or else interest rates need to come down at the kind of aggressive pace indicated above. More light will be shed on this picture in the corporate reporting season that is now just getting started.

But for the time being, a lack of earnings growth, exaggerated interest rate expectations, the risk of exogenous geopolitical shocks, and (last but not least) the persistently low level of risk indicators – think "equity market volatility" – provide clear arguments for an underweight stance. Indeed that is what we are implementing by taking profits on European equities in particular.

Alternative Assets

The alternative assets of gold and crypto have also enjoyed significant value gains in recent weeks, but without losing their diversification potential. Given current global tensions, gold can be expected to contribute further to the stabilisation of the portfolio, despite higher real interest rates. Should interest rates start falling, both investments can be expected to appreciate further.

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.

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Appendix

Economic and market development

GDP (E: Consensus)

	2022	2023E
USA	1.9%	2.4%
EU	3.5%	0.5%
Switzerland	2.7%	0.8%

Inflation (E: Consensus)

	2022	2023E
USA	8.0%	4.1%
EU	8.4%	5.4%
Switzerland	2.9%	2.2%

Central Bank Rates (higher)

	16.01.2024	Consensus
USA FED	5.5%	5.50%
EUR ECB	4.0%	4.00%
CHF SNB	1.8%	

Government Bonds (10 Year)

	16.01.2024	Outlook
USA	4.06%	3.80% – 4.20%
Germany	2.26%	2.10% – 2.40%
Switzerland	0.84%	0.75% – 0.95%

Foreign Exchanges

	16.01.2024	Outlook
EUR/CHF	0.937	0.93 – 0.97
USD/CHF	0.862	0.85 – 0.89
EUR/USD	1.088	1.06 – 1.10

Raw Materials and Alternatives

	16.01.2024	Outlook
Gold (USD/Ounce)	2'028	1'950 – 2'050
Oil (USD/Brent)	78.3	70 – 80
Bitcoin USD	43'434	38'000 – 45'000

Equity Markets

	P/E ø 5J.	P/E 2024	Div. Yield	Outlook
World	19.0x	17.5x	2.0%	slightly down
USA	20.7x	19.7x	1.5%	slightly down
Europe	15.8x	12.3x	3.4%	slightly down
Switzerland	19.8x	17.8x	3.0%	slightly down
Emerging Markets	13.8x	11.5x	2.7%	slightly down

Markets in Local Currencies

Equity Markets

	QTD	YTD
World	10.0%	22.8%
USA	10.5%	24.9%
Europe	6.2%	16.0%
Switzerland	2.1%	6.8%
Emerging Markets	2.7%	4.9%

Government Bond Yield (10 Year)

	16.01.2024	29.12.2023
USA	3.92%	3.87%
Germany	2.12%	-0.18%
Switzerland	0.66%	1.62%

Raw Materials and Alternatives

	QTD	YTD
Gold (USD/Ounce)	-1.7%	-1.7%
Oil (USD/Brent)	1.6%	1.6%
Bitcoin USD	3.6%	3.6%

Foreign Exchanges

	QTD	YTD
EUR/CHF	0.9%	0.9%
USD/CHF	2.4%	2.4%
EUR/USD	-1.5%	-1.5%

Data as of 16 January 2024, QTD: Performance since Beginning of Quarter, YTD: Performance since Beginning of Year