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Monthly CIO Letter

27 May 2024

To tame inflation, central banks must be successful in their efforts to push economic growth below its theoretical potential. Pulling off the alternative – increasing potential growth by means of a rise in productivity to a sufficient extent – would be quite an achievement in the current environment, so the current level of optimism in this respect is probably misplaced. The equity quota remains underweight, while the USD quota is being scaled back.

Christoph Boner
Chief Investment Officer

Highlights

- Interest rate expectations have changed significantly in recent months. Given the likelihood of an imminent rate cut by the ECB, we are increasing the duration of EUR bonds.
- The prices of risky assets have so far barely taken into account this change to discount factors.
- Higher growth expectations have a compensating effect – although these obviously harbour potential for disappointment.

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

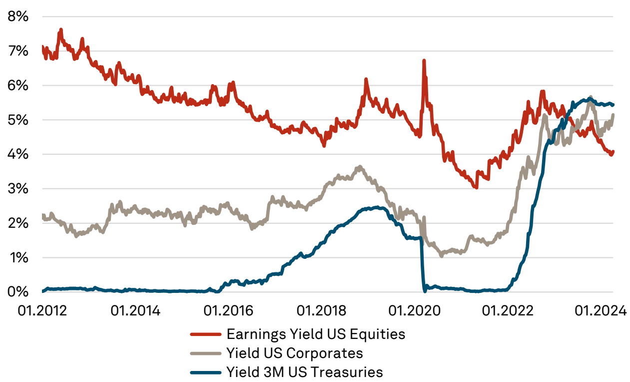
Asset Allocation

The setback experienced by both equity and bond markets in April proved to be only short-lived. On the one hand, prevailing geopolitical tensions do not appear to have concerned investors much, while on the other, revised interest rate expectations – which are fundamentally negative for asset prices – have clearly had no lasting effect.

Back in January, the market was still expecting up to seven interest rate cuts on the part of the Fed, whereas some observers are now even wondering whether interest rate hikes might be on the agenda in the US. This revision of interest rate expectations – a consensus shift towards higher interest rates for a longer period of time – should result in lower asset prices according to traditional theory. The future income streams delivered by such investments are immediately devalued by these higher-than-expected interest rates – with market price declines the logical consequence.

However, in this case the setback has proved to be only short-lived. Over the last week or so, a number of equity markets have actually surged to new record highs; from a historical perspective, some segments are showing indications of overvaluation. A surge of this kind can be justified by a sufficient increase in growth – but this in turn must be even higher against a backdrop of simultaneous rises in interest rates. In other words, the potential for negative surprises where growth is concerned have risen markedly. Riskier investments such as equities and higher-yielding bonds have therefore become less appealing when compared to investment-grade bonds.

Yield comparison: equities and bonds



In the EUR bond segment we are increasing the average duration by 18 months to a new level of 4.4 years. We are leaving the bond allocation for a balanced risk profile at 38%. The high credit quality of the portfolio likewise remains unchanged, as we do not consider lower-quality bonds to be particularly attractive. We also remain positioned in anticipation of a normalisation of the US yield curve.

We are leaving the equity quota for a balanced risk profile at 42%, which is below the strategic allocation. Emerging market equities are neutrally weighted due to their attractive valuations. We are likewise maintaining the relative overweighting of Chinese equities following the positive market developments of recent weeks.

Also unchanged are our diversifying investments in gold and cryptocurrencies, both of which have recently recorded new highs.

Bonds

Against a backdrop of persistently elevated inflation and evidence of the US economy growing above its potential, the guardians of monetary policy in the US have only limited scope for rate cuts as things stand. A maximum of just two rate cuts on the part of the Fed is currently anticipated by investors, with some observers having even flirted with the possibility of rate rises. The reason for the shift in expectations is the fact that the current deglobalisation trend – of which the ramping-up of import tariffs is just the most visible indication – and the prevailing (partly demographically-driven) scarcity of resources in the developed world's labour markets are giving rise to a persistently inflationary backdrop.

Anyone expecting lower interest rates in the near future is taking a very bold stance. That said, exogenous shocks – such as negative geopolitical events, for example – could yet turn out to be a game-changer in this interest rate game.

Here in Europe, the picture looks different: with the current rate of economic growth already being below its potential in many countries of the Eurozone, the ECB has greater leeway to cut rates. The consensus expectation is for an initial step to be taken prior to the summer holidays.

Given these contrasting macroeconomic situations and the corresponding implications for monetary policy going forward, we are lengthening the duration of the EUR bond portfolio to a new level of 4.4 years – an increase of 18 months on our prior positioning. In our view, the slightly lower current yield that this entails (due to the structure of the yield curve) is more than compensated for by the greater interest rate sensitivity in the event of the ECB cutting rates. We remain 18 months below the market duration not just in USD but also in CHF, as no immediate interest rate cuts are expected in Switzerland either.

Given the very low risk premiums available on corporate bonds, we are maintaining the corresponding underweighting of this fixed-income segment. In our view, any increase in exposure here would require a significant widening of credit spreads to compensate for the credit risks assumed.

Equities

Theoretically speaking, the revision of interest rate expectations should lead to a lasting decline in equity prices, with growth stocks – whose income streams are heavily skewed towards the future – being the obvious candidates for a more severe correction. But given the magnitude of the recent revisions to interest rate expectations, the temporary reverses of recent weeks barely merit a mention. Indeed, a number of equity markets have recently surged to new peaks. All things being equal, the accompanying expansion of valuations – with companies on average having only met expectations rather than exceeding them – should necessitate greater growth.

But as previously explained, a backdrop of persistent inflationary pressure is not conducive to higher growth. Thus the solution to mitigating inflationary pressure is greater potential growth, something that can be achieved either through a more ample supply of labour or through higher productivity. While the financial markets are now expecting the increase in growth potential – and therefore higher economic growth generally – to be driven primarily by higher productivity, it should be borne in mind that such a development would be of a structural nature. Not only do such phenomena typically unfold more slowly than desired, the potential for reverses in the meantime is not inconsiderable.

Given the bullish valuations of equity markets right now and the optimistic nature of expectations regarding likely growth, we are more comfortable with a continued underweight stance going forward.

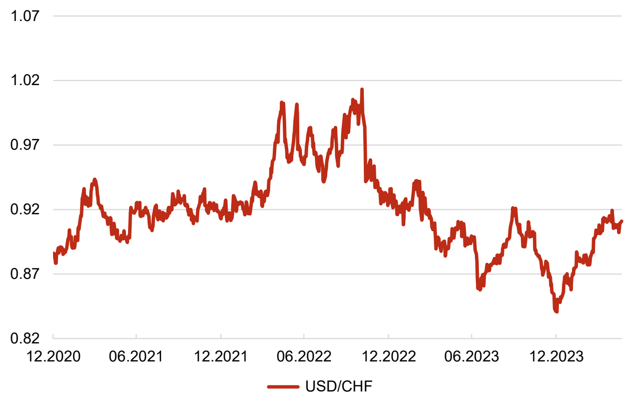
Alternative Assets

Despite the persistently elevated level of interest rates, both gold and selected crypto investments continue to perform strongly – and have temporarily flirted with new highs. Both positions remain unchanged in the portfolio and can be expected to have a stabilising effect in the event of market turmoil.

Currencies

In expectation of the correction to interest rate expectations, our USD positions in the portfolios were largely unhedged for the first few months of the year. With USD now having appreciated by 8% against CHF and by just under 2% against EUR, we are now locking in the corresponding currency gains by increasing the hedging quota for the greenback. For a balanced risk profile, we now have quotas of 5% and 4% for USD and EUR respectively in the portfolios that have CHF as their reference currency. In particular, the normalisation of interest rate expectations removes much of the potential for USD to appreciate further. And where CHF is concerned, it is currently difficult to see why the SNB would feel the need cut rates.

Development of USD/CHF



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Appendix

Economy and Markets

GDP (E: Consensus)

	2023	2024E
USA	2.5%	2.4%
EU	0.5%	1.0%
Switzerland	0.7%	1.2%

Inflation (E: Consensus)

	2023	2024E
USA	4.1%	3.1%
EU	5.4%	2.4%
Switzerland	2.1%	1.3%

Central Bank Rates (higher)

	21.05.2024	Consensus
USA FED	5.5%	5.50%
EUR ECB	4.0%	3.75%
CHF SNB	1.5%	

Government Bonds (10 Year)

	21.05.2024	Outlook
USA	4.41%	4.30% – 4.50%
Germany	2.50%	2.35% – 2.60%
Switzerland	0.80%	0.65 – 0.85%

Foreign Exchanges

	21.05.2024	Outlook
EUR/CHF	0.989	0.95 – 0.99
USD/CHF	0.911	0.89 – 0.93
EUR/USD	1.085	1.05 – 1.09

Raw Materials and Alternatives

	21.05.2024	Outlook
Gold (USD/Ounce)	2'421	2'300 – 2'500
Oil (USD/Brent)	82.9	80 – 90
Bitcoin USD	69'712	55'000 – 75'000

Equity Markets

	P/E ø 5J.	P/E 2024	Div. Yield	Outlook
World	19.2x	17.5x	1.8%	slightly down
USA	21.1x	19.3x	1.4%	slightly down
Europe	15.8x	13.4x	3.2%	slightly down
Switzerland	19.9x	17.2x	2.9%	slightly down
Emerging Markets	13.8x	11.6x	2.7%	slightly down

Markets in Local Currencies

Equity Markets

	QTD	YTD
World	1.6%	10.8%
USA	1.5%	12.2%
Europe	3.5%	11.6%
Switzerland	3.6%	9.8%
Emerging Markets	5.2%	7.8%

Government Bond Yield (10 Year)

	21.05.2024	29.12.2023
USA	4.41%	3.88%
Germany	2.50%	-0.18%
Switzerland	0.80%	0.70%

Raw Materials and Alternatives

	QTD	YTD
Gold (USD/Ounce)	8.6%	17.4%
Oil (USD/Brent)	-3.0%	14.9%
Bitcoin USD	-1.6%	66.2%

Foreign Exchanges

	QTD	YTD
EUR/CHF	1.6%	6.4%
USD/CHF	1.1%	8.3%
EUR/USD	0.6%	-1.7%

Data as of 21 May 2024, QTD: Performance since Beginning of Quarter, YTD: Performance since Beginning of Year