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Monthly CIO Letter

24 June 2024

With the correction to interest rate expectations, the risk barometer has shifted in the direction of growth. Indeed, the equity market is predominantly being driven by growth stocks at the moment – broad-based support is lacking. As geopolitical risks continue to be underestimated, we are stabilising our portfolios further. The equity quota remains underweight, while the allocation is being expanded with Japanese stocks and investments in commodities.

Christoph Boner
Chief Investment Officer

Highlights

- With the interest rate expectations of investors having finally caught up to economic reality, the focus has now switched to growth.
- Given the prevailing growth risks – will AI really deliver the magnitude of growth expected? – current valuation levels look to be high in a historical comparison.
- We are retaining our cautious equity allocation and expanding the portfolio to deliver greater stability in the face of potentially escalating geopolitical risks.

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

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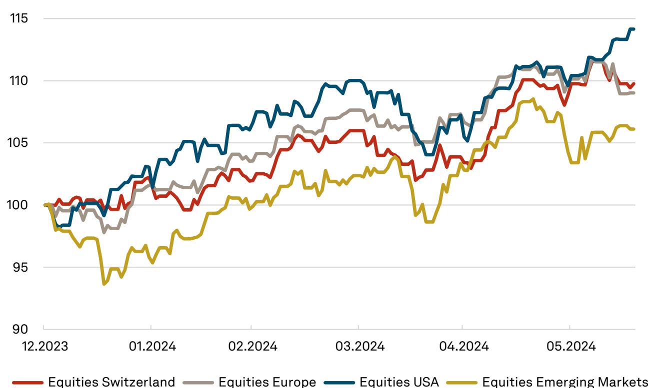
Asset allocation

As highlighted by us several times, the market's very exaggerated expectations in respect of interest rate cuts at the start of the year have normalised to the point where they are now more in line with the true macroeconomic picture. It has become clear that taming inflation is at its most challenging in the "final furlong", not least as base effects evaporate. That said, the kind of correction to capital assets that might been expected now that investors have resigned themselves to "higher for longer" has not occurred. The reason for this is a simultaneous rise in growth expectations. Whether or not this is purely a background market narrative, or whether expectations of productivity increases on the basis of technological advances – AI by any other name – are genuinely justified remains the crucial question. The next issue of our publication "Perspectives" will include some thoughts on the power of narratives.

It is clear that this focus on growth has led to a decline in market breadth as well as major divergences. The greater the proportion of fantasy-fuelled tech stocks held by an investor in recent weeks, the better their portfolio will have performed. Specifically, the technology industry has been the strongest sectoral performer, while the US stock market currently appears to be leaving other equity markets in its wake due to the high proportion of tech stocks it contains.

Equity markets: development of the different regions



This concentration and the decline in market breadth combined with what are now above-average valuation levels confirms our resolve to maintain an underweight equity stance. We are increasing our diversification with the inclusion of Japanese stocks, which traditionally make a strong contribution to diversification given the currency aspect. By contrast, following the recovery of recent weeks we have scaled back our positions in cyclical Chinese equities. We are leaving the equity quota for the "Balanced" risk profile at its current level of 42%, which is below the strategic quota.

We are leaving the bond quota for a balanced risk profile at 38%. We are likewise maintaining the high credit quality of the portfolios, as we do not consider investments in low-quality instruments to be particularly attractive. Similarly, we continue to be positioned in anticipation of a normalisation of the US yield curve.
We are also maintaining our diversifying investments in gold and cryptocurrencies. To further diversify and stabilise the portfolio we are taking positions in commodities, most notably oil. When latent geopolitical risks loom large, these positions traditionally act as a powerful hedge.

Against a backdrop of stretched government budgets and ongoing inflationary pressure in some quarters, diversification will take on even greater significance going forward – the room for future crisis interventions is limited on both the fiscal and monetary policy side.

Bonds

The divergence that has been apparent in the equity markets between the US and Europe in recent weeks has been a feature of the bond market for rather longer. Specifically, inflationary pressure in the US remains high due to persistently strong demand, whereas the economic slowdown has already allowed the ECB to cut interest rates for the first time. The market is currently expecting around two interest rate cuts for the US by the end of the year; the Fed itself is only holding out the prospect of one cut but is leaving itself plenty of leeway given potentially changing data and fresh developments. Where possible rate cuts are concerned, the possibility of exogenous shocks also remains a possible game-changer, even though the scope for such action is likely to be somewhat restricted, given persistently bloated central bank balance sheets and ongoing inflationary fears.

We are leaving the duration at 4.4 years for the EUR bond market, whereas for both CHF and USD our duration remains 1.5 years below that of the market as a whole. Given flat to inverted yield curves, the roll-down effect is too small for greater duration risk to be worthwhile as things stand.

With corporate bond credit spreads still very narrow, we are maintaining our underweight stance where credit risks are concerned. In our view, any greater exposure to this segment would require significantly higher credit premiums to compensate for the additional credit risk assumed.

Equities

With equity markets having already moved above their historical valuation averages in recent weeks, market breadth has also receded sharply over the same period as the focus of the investment community has shifted to growth. For example, the US stock market – with its greater weighting of growth stocks – has outperformed other regions significantly in recent weeks. At the same time, the technology sector's performance has been far superior to the rest of the market. Even within the

technology sector, the degree of market breadth is apparent. At the time of writing, 60% of the stocks in the S&P 500 were trading at levels above their 200-day averages.

A look at valuations within the same index likewise throws up a rather worrying finding: almost a quarter of stocks are now trading at a price-earnings ratio of more than 50 – more than the number of stocks trading below 20.

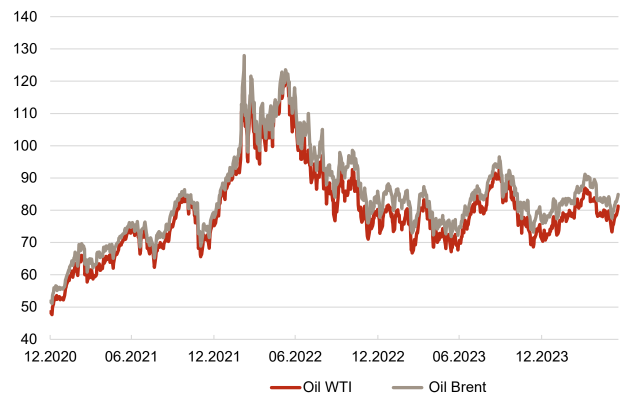
This combination of a lack of market breadth combined with a valuation that is above the historical average highlights the current dependency of the equity market: Earnings growth figures are going to have to live up to these heady expectations, and the scope for further price rises currently looks limited – in short, there is plenty of potential for disappointment.

Given this backdrop, we are leaving the equity quota unchanged, i.e. slightly underweighted. Within the equity allocation we are improving the degree of diversification further and reallocating a proportion of our European equity exposure to Japan, deliberately leaving the currency aspect unhedged. This has the effect of reducing the dependence on growth and increasing the degree of diversification thanks to a relatively closed market. Moreover, we are reducing the market beta of the portfolio by taking profits on Chinese equity investments.

Alternative investments

Despite the persistently elevated level of interest rates, both gold and selected cryptocurrencies have continued to perform impressively – at times soaring to new highs. Both positions remain unchanged in the portfolio and can be expected to have a stabilising effect in the event of market dislocations. As the financial markets continue to play down the magnitude of geopolitical risks, we are increasing our commodity allocation with a structural investment in Brent oil. This will make the portfolio even more resilient in the event of a crisis, while at the same time improving the diversification contribution through a leveraged participation in any price rise. The empirical evidence underlines the diversification potential of commodities in crisis situations.

Oil: development of futures prices



Currencies

As a result of the reallocations in the various asset classes, the USD proportion in the portfolios has risen slightly whereas the EUR proportion has declined; a new currency has been incorporated into the portfolio in the form of the Japanese yen, its proportion being broadly in line with the Japanese equity allocation.

The reference currency proportion for a balanced profile remains at around 75%, with USD accounting for some 6% and EUR less than 4%. The normalisation of interest rate expectations is above all limiting the scope for the USD to appreciate further against CHF. Where the latter is concerned, it is difficult to see why the SNB should feel the need to cut interest rates in the immediate future.

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Appendix

Economy and Markets

GDP (E: Consensus)

	2023	2024E
USA	2.5%	2.4%
EU	0.5%	1.0%
Switzerland	0.8%	1.2%

Inflation (E: Consensus)

	2023	2024E
USA	4.1%	3.2%
EU	5.4%	2.4%
Switzerland	2.1%	1.4%

Central Bank Rates (higher)

	18.06.2024	Consensus
USA FED	5.5%	5.50%
EUR ECB	3.8%	3.75%
CHF SNB	1.5%	

Government Bonds (10 Year)

	18.06.2024	Outlook
USA	4.22%	4.15% – 4.35%
Germany	2.40%	2.30% – 2.55%
Switzerland	0.75%	0.65 – 0.85%

Foreign Exchanges

	18.06.2024	Outlook
EUR/CHF	0.950	0.95 – 0.99
USD/CHF	0.884	0.89 – 0.93
EUR/USD	1.074	1.05 – 1.09

Raw Materials and Alternatives

	18.06.2024	Outlook
Gold (USD/Ounce)	2'329	2'275 – 2'450
Oil (USD/Brent)	85.3	80 – 90
Bitcoin USD	64'891	55'000 – 75'000

Equity Markets

	P/E ø 5J.	P/E 2024	Div. Yield	Outlook
World	19.3x	17.6x	1.8%	slightly down
USA	21.1x	19.8x	1.3%	slightly down
Europe	15.8x	13.2x	3.3%	slightly down
Switzerland	19.9x	17.4x	3.0%	slightly down
Emerging Markets	13.8x	11.3x	2.7%	slightly down

Markets in Local Currencies

Equity Markets

	QTD	YTD
World	3.0%	12.3%
USA	4.8%	15.8%
Europe	2.2%	10.2%
Switzerland	3.7%	9.9%
Emerging Markets	4.4%	7.0%

Government Bond Yield (10 Year)

	18.06.2024	29.12.2023
USA	4.22%	3.88%
Germany	2.40%	-0.18%
Switzerland	0.75%	0.70%

Raw Materials and Alternatives

	QTD	YTD
Gold (USD/Ounce)	4.5%	12.9%
Oil (USD/Brent)	0.4%	19.1%
Bitcoin USD	-8.4%	54.7%

Foreign Exchanges

	QTD	YTD
EUR/CHF	-2.4%	2.2%
USD/CHF	-1.9%	5.1%
EUR/USD	-0.5%	-2.7%

Data as of 18 June 2024, QTD: Performance since Beginning of Quarter, YTD: Performance since Beginning of Year