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PostFinance

Editorial

Real estate acts as an anchor

This year has been very disappointing for everyone in terms of investments. Rising capital market interest rates, in particular, weighed heavily on the markets in the first six months. Bond yields have never risen as sharply as they did this year. This not only resulted in devastating losses on the bond markets, but practically all asset classes were severely hit. Only commodities achieved gains.

Philipp Merkt
Chief Investment Officer

A more settled situation has emerged on the financial markets since mid-June as there was a trend reversal in longer-term interest rates. This was partly due to a technical correction after the rapid rise beforehand, but the lower interest rates also reflect growing scepticism over the growth outlook for the global economy.

Yet, the impact is still being felt. The bond markets – depending on the currency and debtor quality – are now trading at between 5 and 15 percent below year-opening levels. Losses on equities are generally greater and even the value of investments in Swiss real estate funds fell sharply by 10 percent on average.

The latter is striking for many observers because real estate prices themselves haven't fallen yet despite rising mortgage interest rates. The funds' negative yields are explained by investors no longer being willing to pay a premium on existing real estate portfolios. The premium – in other words the extra amount investors are willing to pay above the estimated value of the properties – has actually fallen.

A year ago, this premium stood at an average of over 40 percent of the estimated value or net asset value. On one hand, the premium reflects the price, enabling an attractive distribution yield of almost 3 percent to be generated with little management effort required. On the other, the expectation of more real estate price rises lay behind these historically high figures.

"The bubble has burst on Swiss real estate fund market. Attractive distribution yields can now be acquired at fair prices."

Further increases in real estate prices were considered less likely, given higher interest rates and the prospect of an economic slowdown. The excess yield of real estate investments compared to bonds also fell. Both factors have led to much lower premiums over recent weeks. This means investing in real estate funds is now an attractive option again based on current values. As demand – at least for residential property – looks set to rise further in light of sustained immigration and low vacancy rates, the funds investing in this sector also remain fundamentally attractive. In view of the decline in new build activity, we expect real estate prices to fall much less sharply than equities and bonds, even with moderately rising interest rates. This is why we're recommending an overweighted position in Swiss real estate funds in the portfolio.

Given the slightly worse economic outlook and the more moderate rise in longer-term interest rates expected, we're also increasing the bond allocation in Swiss francs back to neutral – but we're maintaining an underweighted position in bonds overall.

Positioning

Economic situation points to downside potential for equities

The economy is slowing down. This should bring the surge in inflation – in the USA for the time being – to a halt.

The mood on the financial markets has clearly improved over recent weeks. Just two months ago, market participants were so concerned about inflation that sentiment on the stock markets plummeted, sending equity prices tumbling. There were fears that central banks would have no option but to drastically raise key rates. If interest rates rise, not only do bond prices fall, but – as in the first half of the year – the prices of equity and real estate investments also decrease.

"But the monthly data collected on consumer confidence and business sentiment is increasingly contradicting the positive assessment."

This analysis has now been significantly revised. While market participants in the USA still anticipate further key rate rises of around 1.3 percentage points, the first *rate cuts* are expected to be made from mid-2023. And, in June, the Swiss National Bank was still expected to raise interest rates up to 2 percent in Switzerland. This forecast has now been reduced to below 1percent.

One reason for this change of mood was the recent inflation figures from the USA. In July, inflation came in at 8.5 percent. In the prior month, it still stood at 9.1 percent. And the core inflation rate measuring the price trend excluding energy and food, which is more relevant to monetary policy, fell for the fourth consecutive time.

Performance of asset classes

Asset class		1M in CHF	YTD [1] in CHF	1M in LCY [2]	YTD [1] in LCY [2]
Currencies	EUR	–1.6%	–6.3%	–1.6%	–6.3%
	USD	–4.2%	3.1%	–4.2%	3.1%
	JPY	–1.0%	–10.7%	–1.0%	–10.7%
Fixed Income	Switzerland	2.1%	–11.8%	2.1%	–11.8%
	World	4.4%	–9.6%	9.0%	–12.4%
	Emerging markets	4.9%	–9.3%	9.6%	–12.1%
Equities	Switzerland	6.0%	–17.1%	7.7%	–11.5%
	World	2.0%	–1.2%	3.9%	6.1%
	USA	0.0%	–13.0%	1.0%	–2.6%
	Eurozone	–0.7%	–13.4%	3.6%	–16.1%
	United Kingdom	2.2%	–7.5%	2.2%	–7.5%
	Japan	–1.6%	–9.5%	2.7%	–12.2%
	Emerging markets	1.8%	–13.5%	6.3%	–16.1%
Alternative Investments	Swiss real estate	2.1%	–10.8%	2.1%	–10.8%
	Gold	–1.1%	2.6%	3.3%	–0.5%

[1] Year-to-date: Since year start
[2] Local currency

Data as of 11.08.2022
Source: Web Financial Group, MSCI, SIX, Bloomberg Barclays, J.P.Morgan

Another factor is that market participants increasingly anticipate an economic slowdown. This will – hopefully – help further curb inflation without inflicting major damage on the economy.

Economic slowdown points to downside potential for equities

But the monthly data collected on consumer confidence and business sentiment is increasingly contradicting this positive assessment. A mild downturn seems increasingly less likely. Consumer confidence in western industrial nations has plummeted to virtually an all-time low. High inflation rates are eroding consumers' purchasing power. Strong business sentiment is now also fading away. This may also mean a turnaround in corporate earnings, bringing an end to the profits bonanza of the past 24 months. This is why we're remaining cautious over equity investments.

Bonds more attractive again

We reduced the bond allocation in our portfolios at the start of the year as we expected rising interest rates and falling prices as a result. Our forecast proved correct.

But the economic slowdown and our forecast that the equity markets will suffer sporadic downturns means now is a good time to purchase bonds again. We're increasing our allocation to Swiss bonds, returning them to a neutral position in our portfolios.

Real estate investments more attractive than equities

Rising interest rates in the first half of the year hit listed Swiss real estate funds hard. Prices were down 20 percent on the 2021 year-end figure for a time. We're taking advantage of this fall in prices to build up positions in these investments. Measured in terms of historic prices and interest rates, we consider the current valuation to be fair. The current supply and demand trends seem very robust in our view which is why we don't expect a price slump, even if there's an economic slowdown. While immigration – and, consequently, demand for living space – continues to rise sharply, supply is increasingly lagging behind. Fewer homes are being built in Switzerland year after year.

Positioning relative to long term strategy: Swiss focus

Asset class		TAA[1] old	TAA[1] new	underweighted[3] ––	–	neutral[3]	+	overweighted[3] ++
Liquidity	**Total**	**15.0%**	**11.0%**					
	CHF	15.0%	11.0%					
Fixed Income	**Total**	**27.0%**	**29.0%**					
	Switzerland	15.0%	17.0%					
	World[2]	6.0%	6.0%					
	Emerging markets[2]	6.0%	6.0%					
Equities	**Total**	**44.0%**	**44.0%**					
	Switzerland	23.0%	23.0%					
	USA	6.0%	6.0%					
	Eurozone	3.0%	3.0%					
	United Kingdom	2.0%	2.0%					
	Japan	2.0%	2.0%					
	Emerging markets	8.0%	8.0%					
Alternative Investments	**Total**	**14.0%**	**16.0%**					
	Swiss real estate	7.0%	9.0%					
	Gold[2]	7.0%	7.0%					

[1] Tactical Asset Allocation: short to mid-term orientation
[2] Currency hedge to CHF
[3] Positioning relative to our long-term asset allocation

— Adjustment compared to last month

Market overview
Fixed income

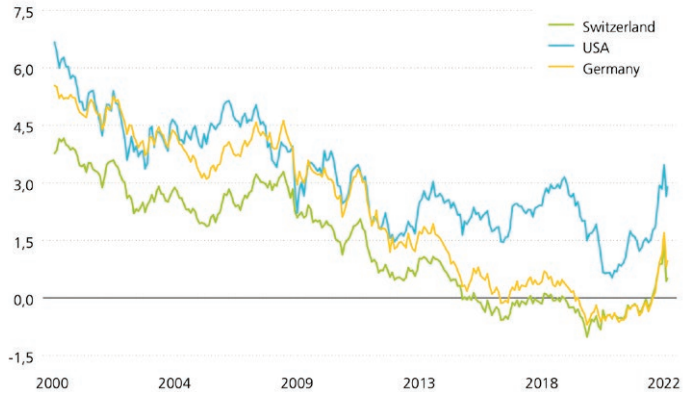
The financial markets appear increasingly aware of the greater risk of recession. Demand for secure government bonds rose again as the second half of the year began. Almost all asset classes were buoyed by falling capital market interest rates.

Indexed performance of government bonds in Swiss francs
100 = 01.01.2022

The bond markets suffered heavy losses during the first six months of the year. Swiss government bonds with a 10-year term briefly fell by over 15 percent. Measured in Swiss francs, their German counterparts saw similar losses. Only US government bonds fell less sharply, but this was due to the performance of the exchange rate. The tide now appears to have turned as we move into the second half of the year, and the bond markets made gains on a broad basis. The value of Swiss government bonds climbed by over 6 percent. One reason for this abrupt trend reversal may be a growing awareness amongst market participants that a recession – at least a mild one – appears inevitable.

Source: SIX, Bloomberg Barclays

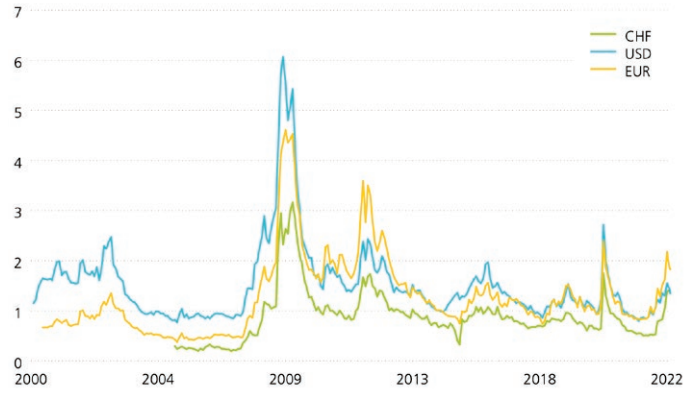
Trend in 10-year yields to maturity
In percent



Capital market interest rates fell significantly last month. Yields to maturity on 10-year US government bonds peaked sharply. Standing at 1.5 percent at the start of the year, they doubled within less than six months to 3.5 percent by mid-June, before dropping equally rapidly to a level of 2.7 percent. Yields to maturity on German and Swiss 10-year government bonds decreased by 100 basis points during this period – to 0.9 percent and 0.5 percent respectively. This sharp fall in capital market interest rates is attributable to fears over a recession, but still boosted almost all asset classes.

Source: SIX, Bloomberg Barclays

Credit spreads on corporate bonds
In percentage points



In line with the equity market recovery, credit spreads on higher-risk corporate bonds also narrowed last month. The spreads on European corporate bonds decreased significantly. Owing to the tense situation on the European energy market caused by the Ukraine conflict, credit spreads briefly climbed to over 2 percent. The risk premium on Swiss government bonds – currently standing at 1.5 percent on average – is lower, indicating that they are considered comparatively more secure by investors.

Source: Bloomberg Barclays

Market overview

Equities

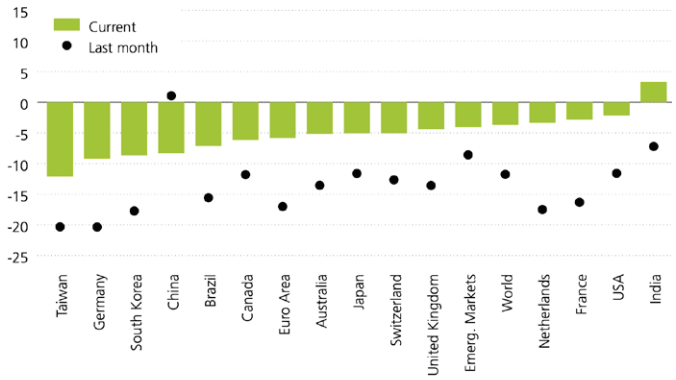
There was a summer upturn on the equity markets last month thanks to falling interest rates. The challenging economic situation is still not yet reflected in corporate earnings.

Indexed stock market performance in Swiss francs
100 = 01.01.2022

There was an upturn on the stock markets last month, which may have been triggered by falling capital market interest rates, with fears over inflation and a recession temporarily cast aside. In turn, the price trend since the second half of the year began has been positive. The MSCI World Index made gains of around 8 percent, while the technology-oriented Nasdaq Index climbed by 13 percent. This means some of the losses from the six months have already been recouped. By contrast, the Swiss equity market was very sluggish.

Source: SIX, MSCI

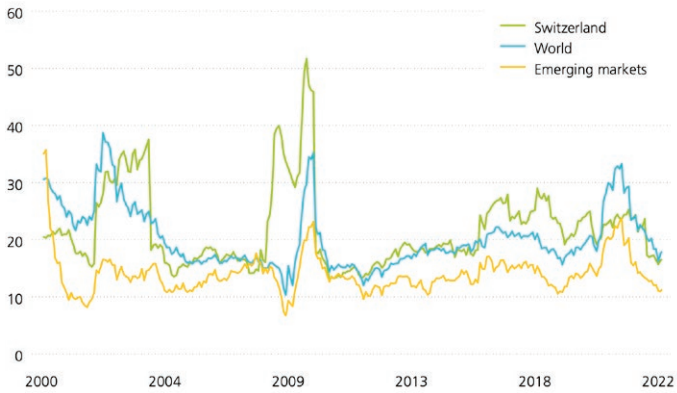
Momentum of individual markets
In percent



Despite the recent summer rally, there is still a negative trend on almost all equity markets on a country-by-country basis. This is due to the heavy losses suffered in the first half of the year. However, the picture is far brighter than in the previous month. Unsurprisingly, Taiwan and Germany fared worst. While Taiwan is still in the geo-political spotlight after China's claims to power, Germany still hasn't resolved its energy problem – actually far from it! Unless sufficient energy-saving measures are introduced, a difficult winter may lie ahead, which could hit the German economy, in particular.

Source: MSCI

Price/earnings ratio
P/E ratio



The price/earnings ratio also fell sharply after the price corrections in the first half of the year. Based on a global average, equity prices are equivalent to 17 times corporate earnings. Just a few months ago, the P/E ratio stood at 34. If there's a recession, this figure is likely to fall further as companies would then face a decline in revenues and profit margins. But there's no indication of that just yet. Higher purchase prices can largely be passed onto consumers, and profit margins are still at historic highs despite the slight decline. And analysts are still forecasting growth in global corporate earnings of 8 percent.

Source: SIX, MSCI

Market overview

Swiss real estate investments

After significant price corrections in the first half of the year, listed Swiss real estate funds enjoyed an upturn last month.

Indexed performance of Swiss real estate funds
100 = 01.01.2022

After a difficult start to the year – with prices falling by up to 18 percent at one point – listed Swiss real estate funds made gains again last month. This increase was mainly due to interest-rate fluctuations on the capital markets. Year-to-date losses currently only stand at 10 percent.

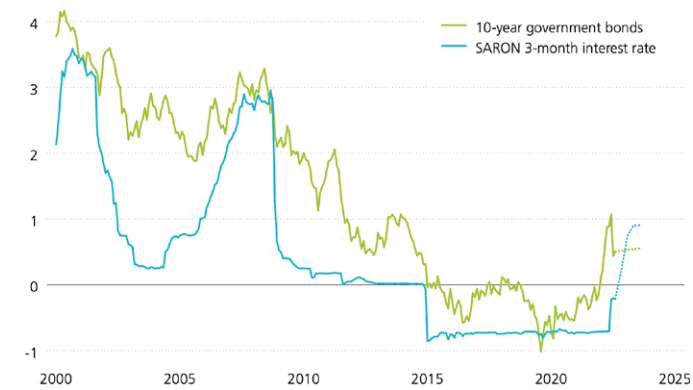
Source: SIX

Premium on Swiss real estate funds and 10-year yields to maturity
In percent

The sharp price corrections on the Swiss real estate market in the first half of the year have led to a fall in the historically high premiums. While buyers were paying a premium of up to 53 percent of property values on average at one point, they now stand at 21 percent on average. Considering the current level of interest rates, listed Swiss real estate investments are now fairly valued again. Major price corrections are now less likely again in view of the valuation level.

Source: SIX

3-month SARON and 10-year yields to maturity
In percent



Mortgages have become much more expensive this year owing to the sharp rise in capital market interest rates. Yields to maturity on Swiss government bonds with a 10-year term briefly rose from 0 percent at the beginning of the year to 1 percent, before falling again slightly. Short-term interest rates – such as the 3-month SARON, which is used as a basis for variable rate mortgages – saw a first sharp rise recently after remaining relatively flat for many years.

It's interesting that futures markets currently expect short-term interest rates (SARON) to rise by a further 1 percent over the coming 12 months, while 10-year yields to maturity, by contrast, will remain at the current level. This would make long-term mortgages less expensive than short-term ones – a very unusual situation. But the prices on the futures markets are extremely volatile and conditions can change quickly.

Source: SIX

Market overview

Currencies

The strong gains made by the US dollar since the start of the year temporarily stopped last month. In contrast, the cyclical currencies, particularly commodity ones, saw an upturn.

The strengthening of the US dollar since the start of the year now seems to have slowed for the time being. The US currency even fell slightly against the major currencies (dollar index) recently, but is still up by 10 percent since the start of the year. In view of high US inflation, the US dollar is significantly overvalued against the currencies of the major trading partners in terms of purchasing power parity according to our calculations, which points to a downturn risk. The global reserve currency is currently very popular again with investors as a safe haven, given the current economic and geopolitical instability.
The euro also suffered losses last month. This was not just due to geopolitical tensions over the Ukraine conflict, but also reflects economic concerns, especially in relation to energy supply in Europe over the winter months ahead.

Currency pair	Price	PPP [1]	Neutral area [2]	Valuation
EUR/CHF	0.97	0.86	0.80–0.92	Euro overvalued
USD/CHF	0.94	0.73	0.64–0.83	USD overvalued
GBP/CHF	1.15	1.25	1.08–1.42	Pound neutral
JPY/CHF	0.71	0.97	0.82–1.13	Yen undervalued
SEK/CHF	9.36	9.24	8.36–10.13	Krona neutral
NOK/CHF	9.88	10.59	9.46–11.72	Krona neutral
EUR/USD	1.03	1.17	1.02–1.32	Euro neutral
USD/JPY	133.01	75.49	60.85–90.13	Yen undervalued
USD/CNY	6.74	5.49	5.23–5.76	Renminbi undervalued

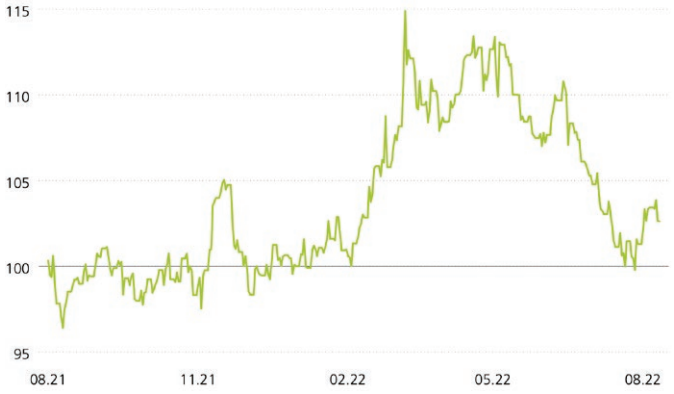
[1] Purchasing power parity. This metric calculates an exchange rate using relative inflation rates.
[2] Range of historically normal fluctuations.

Source: Web Financial Group

Gold

The gold price resisted the general downward trend during the first half of the year. But the precious metal began to falter recently, with its price briefly dipping to 1,700 US dollars.

Indexed performance of gold in Swiss francs
100 = 01.01.2022



Gold withstood the general downward trend remarkably well during the first half of the year, measured in Swiss francs, and was up by 15 percent at times. But the precious metal began to falter from May, falling to its year-opening level. The price per troy ounce has since remained below the 1,800-US-dollar mark.

Source: Web Financial Group

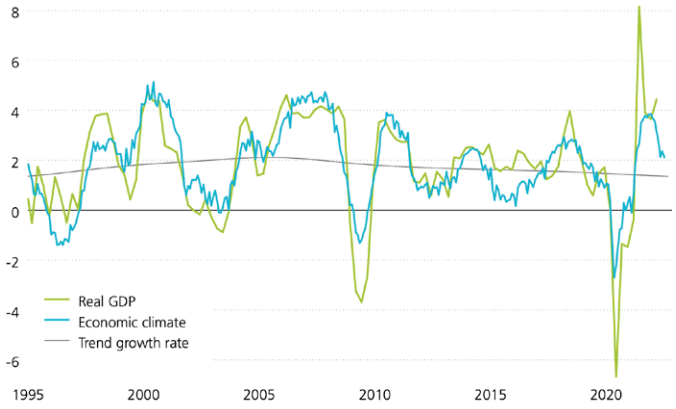
Economy

Economic data deteriorates worldwide

After both the USA and China reported negative growth in the second quarter, the slowdown has become clearly evident. A further decline in economic activity is expected.

Switzerland

Growth, sentiment and trend
In percent

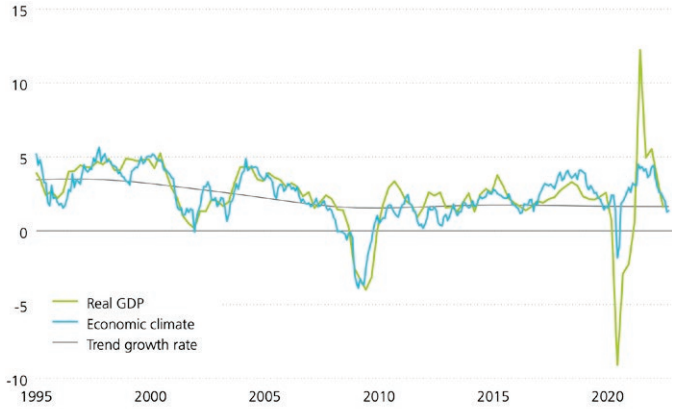


Source: Bloomberg

The outlook for the Swiss economy suffered a major setback last month. Consumer confidence fell to a new all-time low. Consumers were particularly pessimistic about past and expected economic performance. What was also striking is that inflation forecasts are now having a significant impact on sentiment. Job security is still considered as high in keeping with the still comparatively positive mood of companies. But as we've seen business sentiment gradually shift into line with consumer confidence in other industrial nations, it now appears Switzerland is facing a slowdown too.

USA

Growth, sentiment and trend
In percent

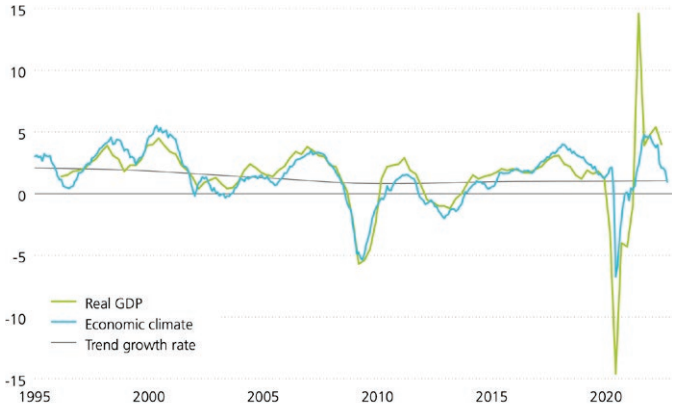


Source: Bloomberg

In the USA, growth in national income fell slightly into negative territory once again in the second quarter. Even though this figure is not classed as a recession, we feel justified in taking a more cautious approach to the US economy. Adjusted for inflation, the income and expenditure figures of private households have now entered negative territory. Essentially, the extremely low consumer confidence is probably due to surging inflation. Even though labour market figures remain robust for the time being, a consumption-induced recession in the USA is expected whether we like it or not. The only glimmer of light is that this slowdown in growth – as we saw last month – should result in lower inflation rates, at least in the short term.

Eurozone

Growth, sentiment and trend
In percent

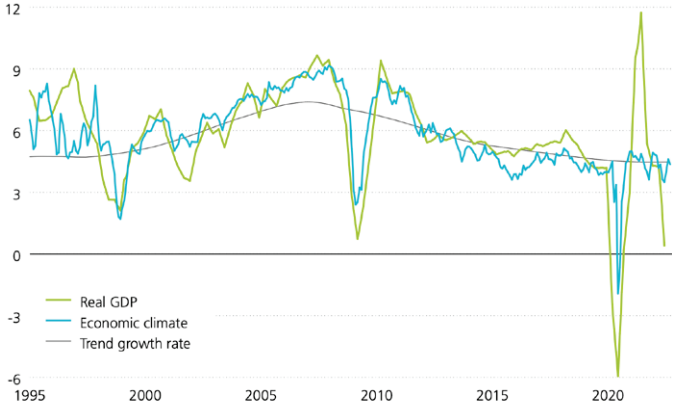


Source: Bloomberg

Unlike the USA, the eurozone also achieved considerable growth in the second quarter. The very different fiscal policies of the two economic areas is a major factor here. While the budget deficit in the USA – which accounted for over 10 percent of national income during the coronavirus crisis – has now fallen, the need for fiscal consolidation in Europe is only half as great. Some economic programmes are only having an impact this year. But the leading indicators for the eurozone plummeted again last month. Owing to the impact of the Russian war of aggression on consumer confidence and gas prices, we also expect much lower growth rates over the coming quarters in Europe.

Emerging markets

Growth, sentiment and trend
In percent



Source: Bloomberg

After negative growth in the second quarter, the Chinese economy is failing to gain momentum. Recently imposed coronavirus restrictions are holding back the partly perceptible recovery. The situation on the real estate market remains precarious and government support measures are not yet having an impact. So it's hardly surprising that consumer confidence in China remains at a historic low point. Meanwhile, the economic indicators in India are comparatively positive. Industrial production is growing strongly and consumer confidence remains on an upward trajectory for the time being. Government interventions in commodity prices to support low-income households are having a positive economic impact, but are weighing on India's budget and so don't seem sustainable.

Global economic data

Indicator	Switzerland	USA	Eurozone	UK	Japan	India	Brazil	China
GDP Y/Y [1] 2022Q1	4.5%	3.5%	5.4%	8.7%	0.7%	4.1%	1.7%	4.8%
GDP Y/Y [1] 2022Q2	–	1.6%	4.0%	2.9%	1.1%	–	–	0.4%
Economic climate [2]	↘	↘	↘	↘	→	→	↘	→
Trend growth [3]	1.4%	1.6%	0.8%	1.7%	1.1%	5.1%	1.3%	4.0%
Inflation	3.4%	8.5%	8.9%	9.4%	2.4%	6.7%	10.1%	2.7%
Key rates	–0.25%	2.50%	0.50%	1.75%	–0.10%	5.40%	13.75%	4.35%

[1] Growth compared to year-ago quarter
[2] Indicator, measuring the overall sentiment and typically leading 1 to 2 quarters in advance of GDP. Green arrow indicates an increasing economic growth, red arrow a slowing.
[3] Potential growth. Long-term change in gross domestic product with sustainable capacity utilization.

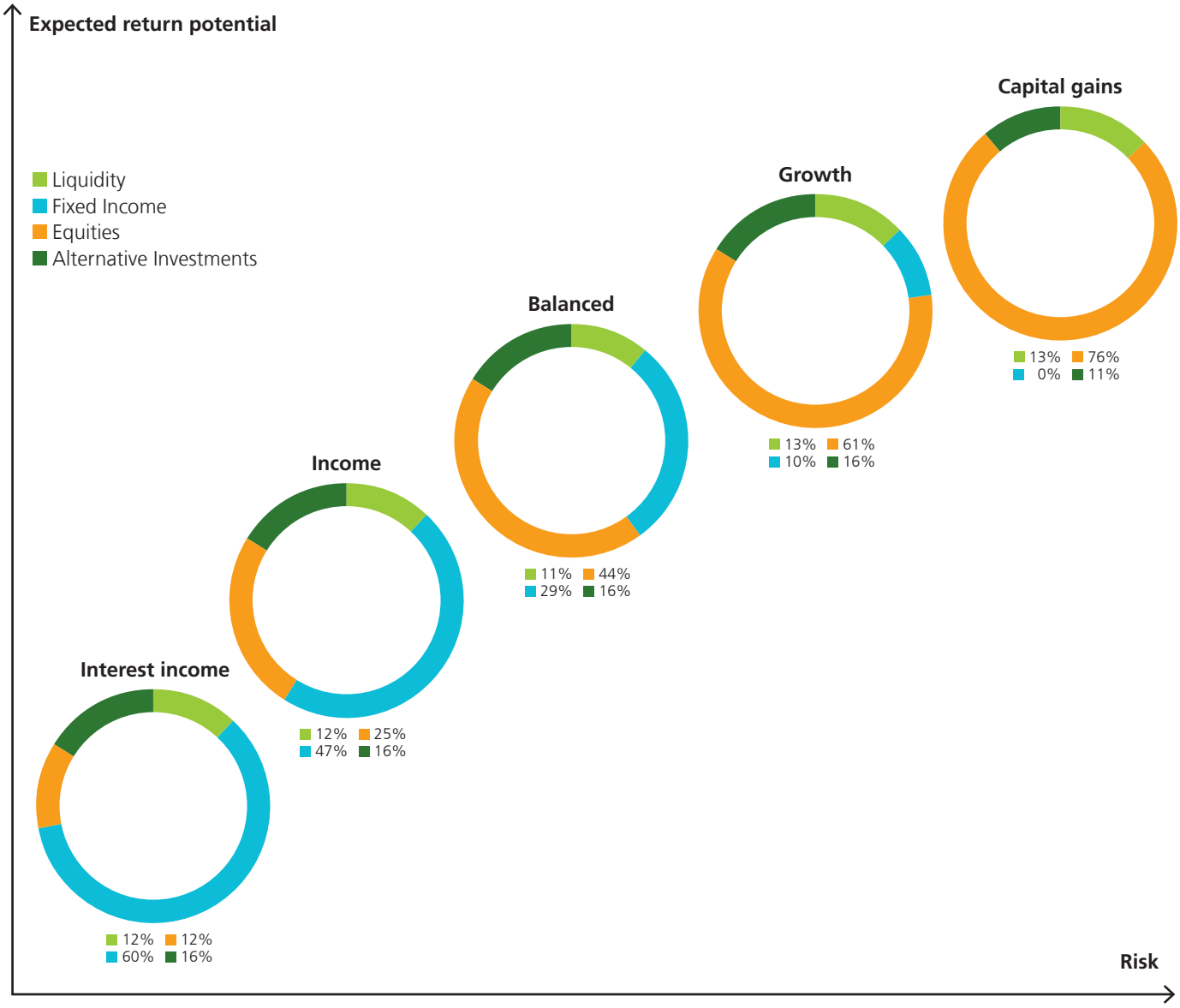
Source: Bloomberg

Model portfolios Swiss focus

Take advantage of the price decline in real estate investments

Listed Swiss real estate funds have corrected significantly since the beginning of the year. At times, fund prices have lost up to 20 percent. As a result, the premiums (or agios) that investors pay for these investments have also fallen significantly. Measured against the current interest rate level, the currently traded premiums are fair. We are thus taking advantage of the price slump of the last few months to make additional purchases.

The looming economic slowdown is likely to put sporadic pressure on share prices. We therefore remain cautious on equity investments. On the other hand, the economic development argues in favour of adding to bonds.



Source: PostFinance Ltd

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