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PostFinance

Editorial

Looking to the New Year with a note of caution

A successful year on the financial markets is coming to an end. A repeat of this performance in 2022 seems unrealistic. Leaving the party too early isn't a good idea, though – neither on New Year's Eve nor on the financial markets.

Daniel Mewes
Chief Investment Officer

I must admit that I expected more optimism about the New Year on the financial markets. Have the coronavirus blues at the end of the second year of the pandemic passed me by?

The scepticism can't possibly come from 2021. Last year was an extremely successful one on the financial markets. After a strong recovery of economic activities, the equity, real estate and commodities markets all made impressive gains. Losses on the bond markets were also contained – in light of the economic recovery, interest rates have risen much less sharply than might have been expected.

No repeat of 2021's recovery

Will we see a repeat of this magic in 2022? Unfortunately, there's little to indicate that happening. We already have very high valuations for equities, real estate and bonds. The economic catch-up is over for the time being, with little scope for rising growth rates. China is faltering. Various geopolitical conflicts are playing out between the major powers of Russia, China and the USA. And there's much to suggest that the new Omicron variant will present challenges for the economy and society over the winter months.

However, in terms of the financial markets, I'm much more concerned about the current high inflation rates. That's because they will give the central banks much less scope to intervene in future crises.

Are we entering a new era?

We anticipate that the Omicron variant will cause tremendous upheaval on the financial markets and in the economy. What will the US Federal Reserve do if that transpires? It will only be able to hope that the recession causes inflation rates to fall sharply, so that it can continue its support policy. But if inflation rates remain high – for example, because the Omicron variant leads to new restrictions in production or logistics – it will face very difficult decisions. Should it support the economy now or tackle inflation?

«In terms of the financial markets, I'm much more concerned about the current high inflation rates.»

Persisting higher inflation would take us into a new era. The economy and financial markets would have to become more independent. This means that the economy and financial markets would not be able to rely on the support of politicians or the central banks if headwind emerges again, but would instead have to overcome these setbacks themselves. But are the economy and financial markets actually ready for that?

Caution is advised – but not too much

Our positioning at year-end reflects this caution. We don't believe we'll see a repeat of 2021. But now is also not the most opportune moment to reduce risks significantly. The economy still rests on a solid foundation at the moment. Over the short term, there's much to indicate that the central banks will scale back their support policy more quickly, but still with a high degree of caution overall. Leaving the party too early isn't a good idea – neither on New Year's Eve nor on the financial markets.

Positioning

Outlook becoming more uncertain

Greater restraint in US monetary policy raises the risks for the US equity market – particularly in light of its high valuations. We're currently using a slight correction to Swiss real estate funds to close our underweighted position.

US inflation rates hit a new high of 6.8 percent in November – a level not seen since the 1980s. The bright economic outlook still points to continued pressure on inflation – despite the declining contribution of energy prices over the coming months. Chair of the Federal Reserve Jay Powell also believes that inflation risks are high over the medium term, as he recently conceded before a Senate committee. This means that the expansive monetary policy is likely to end faster. If the new Omicron variant turns out to be a greater threat to the economy and financial markets, there would be less room for manoeuvre in monetary policy than a year ago, due to higher inflation. More restrained monetary policy could have a negative impact on the US markets. As a result, there is growing uncertainty on the investment horizon.

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Reduction of US risks

The new coronavirus variant spooked the equity markets last month. Prices fell sharply but recovered quickly to hit new record highs in the USA. This means that US equity valuations remain at very high levels, which have only ever been exceeded during the dotcom bubble. Although economically strong leading indicators still support the high valuations, normalization is likely, especially with less supportive monetary policy. For this reason, we regard the upturn potential of US equities as limited. The situation in Japan is very different, however: firstly, Japan still has much more catch-up potential than other industrialized nations. Secondly, with inflation standing at 0.1 percent in October, Japan is faced with hardly any inflationary pressure. And finally, the Japanese yen is very attractively priced against the Swiss franc – in complete contrast to the US dollar. That's why we're reducing the risk in US equities and buying Japanese equities instead.

Performance of asset classes

Asset class		1M in CHF	YTD [1] in CHF	1M in LCY [2]	YTD [1] in LCY [2]
Currencies	EUR	–1.2%	–3.5%	–1.2%	–3.5%
	USD	1.4%	4.3%	1.4%	4.3%
	JPY	0.8%	–5.0%	0.8%	–5.0%
Equities	Switzerland	0.8%	20.8%	0.8%	20.8%
	World	–0.3%	24.9%	–1.7%	19.7%
	USA	0.4%	29.4%	–0.9%	24.0%
	Eurozone	–3.7%	15.7%	–2.5%	19.9%
	United Kingdom	0.0%	19.6%	1.2%	18.5%
	Japan	–0.2%	7.4%	–1.0%	13.0%
	Emerging markets	–0.5%	2.8%	–1.9%	–1.5%
Fixed Income	Switzerland	0.6%	–0.5%	0.6%	–0.5%
	World	0.2%	–0.3%	–1.2%	–4.5%
	Emerging markets	0.2%	2.4%	–1.2%	–1.9%
Alternative Investments	Swiss real estate	–3.1%	3.5%	–3.1%	3.5%
	Gold	–1.5%	–1.8%	–2.8%	–5.9%

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

Data as of 9.12.2021
Source: Web Financial Group, MSCI, SIX, Bloomberg Barclays, J.P.Morgan

Swiss corporate bonds attractive

Yields to maturity were also more volatile last month. At the same time, risk premiums on corporate bonds rose. In Switzerland, these credit spreads have now exceeded the pre-coronavirus level for companies with good credit standing. This may reflect concerns over the new virus variant. But this also presents a tactical opportunity: we recommend taking an overweighted position in Swiss corporate bonds at the expense of their global counterparts and anticipate a normalization of Swiss credit spreads. We're maintaining a heavily underweighted position in global bonds in light of interest rate change risks.

Closing underweighted position in real estate

Swiss real estate funds underwent a slight correction last month. The valuation is still above the fair level derived from long-term interest rates. However, it seems unlikely that the valuation will return to its fair value in the near future. Price fluctuations this year underlined that demand remains strong, regardless of price. That's why we're using the latest price weakness to neutralize our underweighted position.

Positioning relative to long term strategy: Swiss focus

Asset class		TAA[1] old	TAA[1] new	underweighted[3]		neutral[3]	overweighted[3]	
				––	–		+	++
Liquidity	**Total**	**11.0%**	**9.0%**					
	CHF	11.0%	9.0%					
Equities	**Total**	**50.0%**	**50.0%**					
	Switzerland	23.0%	23.0%					
	USA	10.0%	8.0%					
	Eurozone	3.0%	3.0%					
	United Kingdom	4.0%	4.0%					
	Japan	2.0%	4.0%					
	Emerging markets	8.0%	8.0%					
Fixed Income	**Total**	**29.0%**	**29.0%**					
	Switzerland	17.0%	19.0%					
	World[2]	6.0%	4.0%					
	Emerging markets[2]	6.0%	6.0%					
Alternative Investments	**Total**	**10.0%**	**12.0%**					
	Swiss real estate	5.0%	7.0%					
	Gold[2]	5.0%	5.0%					

[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

Equities

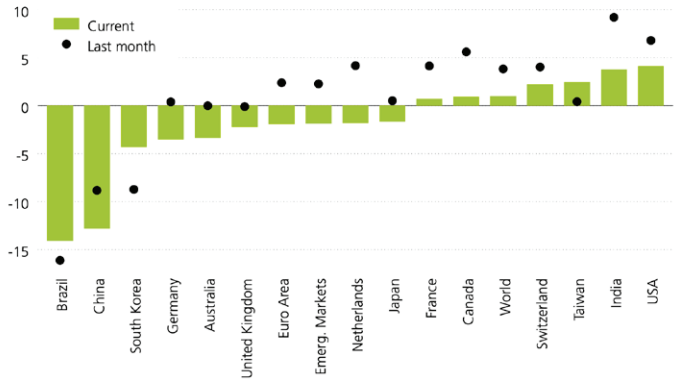
The outbreak of the Omicron variant and the possibility of the US Federal Reserve withdrawing its support policy more quickly triggered downturns on the equity markets. But this did not last long.

Indexed stock market performance in Swiss francs
100 = 01.01.2021

The strong performance of equity prices since spring 2020 has resulted in high valuations. A very positive future is being factored in. This means that equity prices may well react quickly if doubt is cast over this positive future performance. The emergence of the Omicron variant is a factor in this respect. If this variant proves dangerous and cannot be combated effectively with the existing vaccinations, the economic outlook for the coming months will deteriorate. This would result in lower valuations on the global equity markets. As soon as epidemiologists gave some positive news, the equity prices recovered quickly once again.

Source: SIX, MSCI

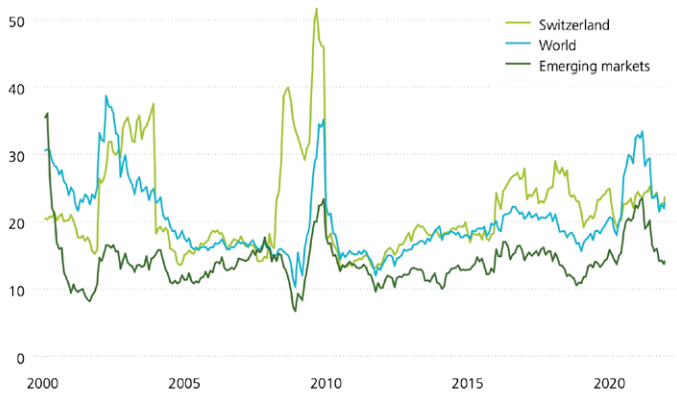
Momentum of individual markets
In percent



The equity markets in the USA and Europe have fluctuated significantly over recent weeks, but the positive underlying momentum remains in place. This does not apply to the Chinese equity market. In addition to the coronavirus situation, the real estate market is also causing anxiety in China. The Chinese authorities are also continuing to show regulatory zeal, trying to gain greater control over systemically important sectors of the economy. This is making it more difficult to list Chinese companies on stock exchanges abroad.

Source: MSCI

Price/earnings ratio
P/E ratio



Equity valuations remain at a high level when measured by price/earnings ratio. Valuations are also based on assumptions over certain interest rate developments. If inflation rates remain high and interest rates also rise, this could create headwind for equity valuations. So it didn't come as a surprise when equities reacted after Jay Powell, President of the US Federal Reserve, held out the prospect of curtailing the bond-buying programme earlier than planned to prepare for an interest rate hike sooner than expected.

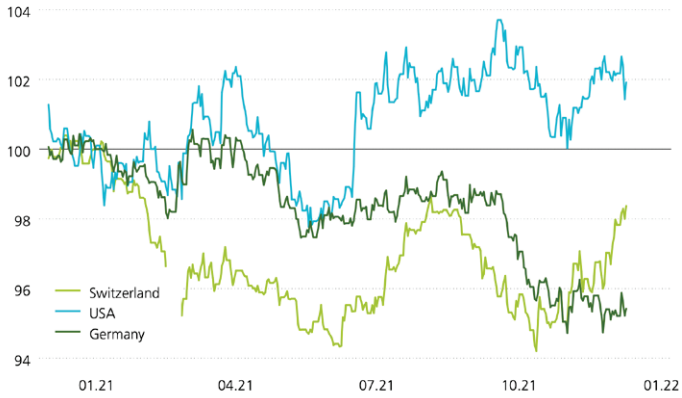
Source: SIX, MSCI

Market overview

Fixed income

Uncertainty over the economic impact of the new coronavirus variant Omicron has triggered a rise in demand for secure government bonds. Credit spreads on corporate bonds have widened.

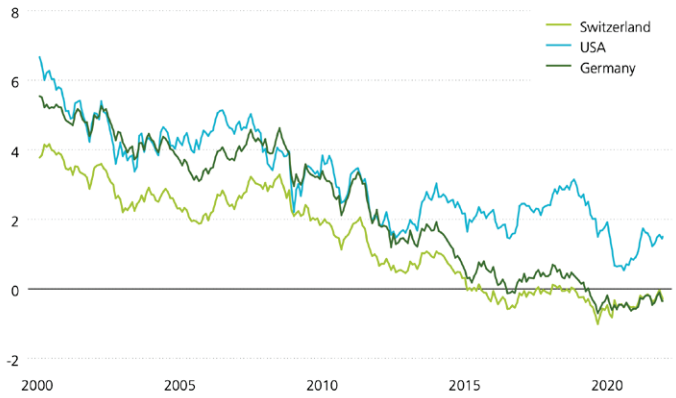
Indexed performance of government bonds in Swiss francs
100 = 01.01.2021



On the bond markets, the issue of inflation has faded into the background somewhat recently. Economic concerns over the emergence of the Omicron variant triggered demand for secure government bonds. But there will be less demand from the US Federal Reserve (Fed) in future. In November, it began tapering its bond-buying programme. The plan is to cut spending on bonds by 15 billion US dollars every month to bring the scheme to an end in June. The Fed will (probably) speed up the scaling back of the programme due to the high inflation trend.

Source: SIX, Bloomberg Barclays

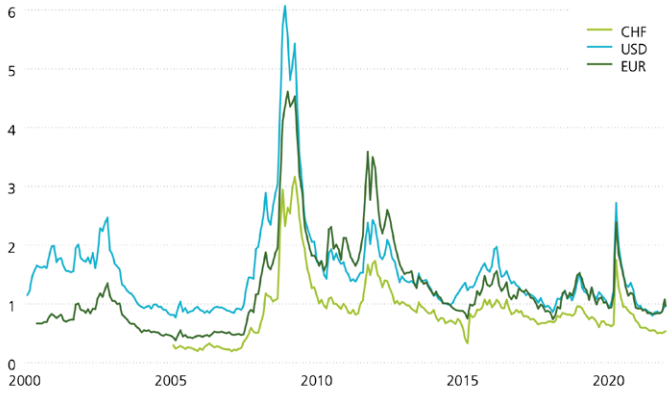
Trend in 10-year yields to maturity
In percent



Apart from short-term uncertainty over the coronavirus pandemic, all the economic signs are looking positive in the USA. Inflation rates hit a new record high of 6.8 percent in November, while wages also rose in the fully stretched labour market. As a result, the US Federal Reserve has indicated that an initial interest rate hike is likely to be introduced soon. Despite this, yields to maturity on 10-year government bonds remain low, standing at 1.5 percent. The European Central Bank is not expected to raise interest rates yet. Yields to maturity in Germany and Switzerland remain at just under zero percent.

Source: SIX, Bloomberg Barclays

Credit spreads on corporate bonds
In percentage points



Greater uncertainty over the economic outlook since the emergence of the Omicron variant has led to a rise in risk premiums on the corporate bond market compared to secure government bonds – while at the same time, the equity markets have suffered setbacks. The risk premiums remain at an historically low level, however.

Source: Bloomberg Barclays

Market overview

Swiss real estate investments

The prices of Swiss real estate funds continue to fluctuate, but at a high level.

Indexed performance of Swiss real estate funds
100 = 01.01.2021

The price trend for indexed Swiss real estate investments continues to undergo significant fluctuations, without any clear direction. After a weak October, prices soared again in November, only to slip back again recently.

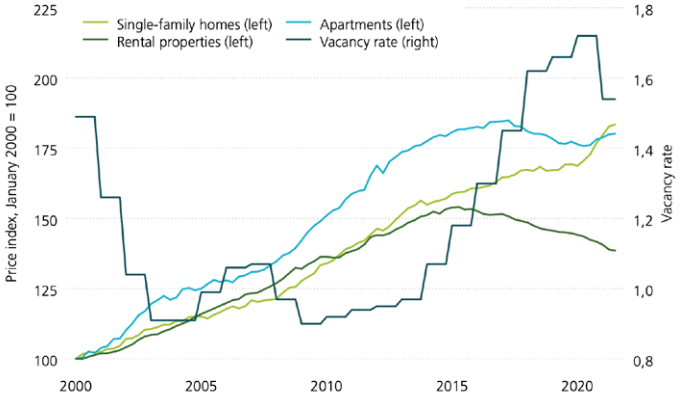
Source: SIX

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

The premium on the properties contained in Swiss real estate funds depends on the level of interest long-term. Persisting low interest rates partly explain the high valuations – but only to some extent. Demand from institutional investors remains strong regardless of the prices.

Source: SIX

Vacancy rate and real estate prices
100 = January 2000 (left) and in percent (right)



Momentum on the Swiss real estate market remains strong. The ratio between house prices and rents now stands at over 30 percent above the long-term average. In other words, it takes an extremely long time to recoup house prices with rental income. The Swiss National Bank has refrained from taking measures so far. But the reintroduction of the anti-cyclical capital buffer – in other words, making banks subject to more stringent capital requirements – seems only a matter of time.

Source: SNB, BfS

Market overview

Currencies

Currencies deemed secure, such as the US dollar, yen and Swiss franc, made gains. The Swiss National Bank has allowed the Swiss franc to appreciate against the euro.

The uncertainty emerging on the financial markets was also reflected on the currency markets. Currencies deemed secure have made gains. The US dollar, Japanese yen and Swiss franc performed particularly well. Inflation rates remain much higher abroad than in Switzerland. The fair exchange rates therefore changed in line with purchasing power parity. Producer price inflation, which is used for this purpose, was extremely high in the eurozone recently. This means that the fair exchange rate is rapidly heading towards parity. For this reason, it's not surprising that the Swiss National Bank has allowed the Swiss franc to appreciate against the euro.

Currency pair	Price	PPP [1]	Neutral area [2]	Valuation
EUR/CHF	1.04	1.02	0.94–1.09	Euro neutral
USD/CHF	0.92	0.83	0.73–0.93	USD neutral
GBP/CHF	1.22	1.37	1.18–1.56	Pound neutral
JPY/CHF	0.81	1.01	0.85–1.17	Yen undervalued
SEK/CHF	10.19	10.71	9.67–11.74	Krona neutral
NOK/CHF	10.26	11.88	10.60–13.16	Krona undervalued
EUR/USD	1.13	1.23	1.07–1.39	Euro neutral
USD/JPY	113.47	81.91	66.95–96.87	Yen undervalued
USD/CNY	6.38	6.23	5.99–6.48	Renminbi neutral

[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 has barely shifted since the summer. Neither uncertainty over the Omicron variant nor high inflation rates appear to be having any effect on it.

Indexed performance of gold in Swiss francs
100 = 01.01.2021

In November, the price per troy ounce briefly rose to over 1,850 US dollars, but for only a brief time. The price has been hovering around the 1,750-dollar mark again recently. The uncertainty on the financial markets and the continued high inflation rates have had virtually no effect on the gold price.

Source: Web Financial Group

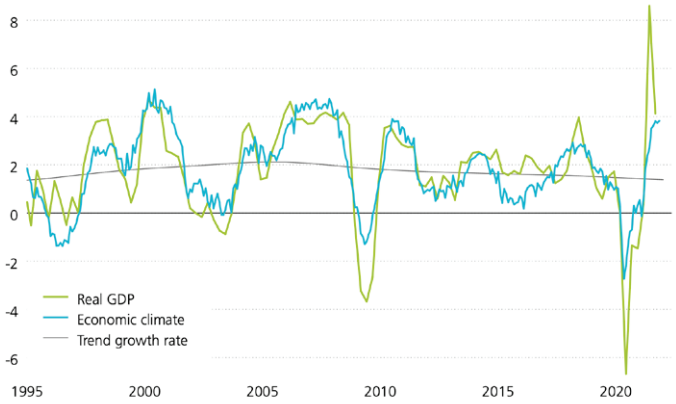
Economy

Highest US inflation for almost 40 years

High coronavirus case numbers are currently creating economic headwind in Europe. However, the economy's resilience in the face of high case numbers has improved since the start of the pandemic. By contrast, inflation may cause issues for some time to come.

Switzerland

Growth, sentiment and trend
In percent

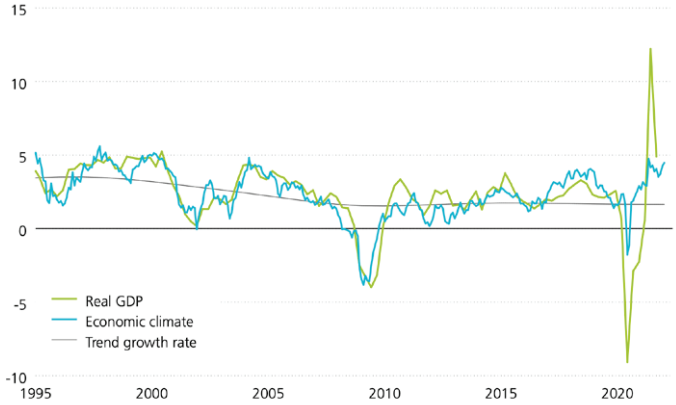


Source: Bloomberg

The Swiss economy achieved growth of 1.7 percent during the third quarter, reaching the pre-crisis level once again. Switzerland is enjoying a rapid recovery by international standards. Growth has been driven by a rise in pharmaceutical exports and by the services sector. Value creation in the pharmaceutical sector is up by 14 percent since the crisis started. The services sector has been boosted by the reopening of restaurants and the return of tourists. However, value creation in the hospitality industry still came in at 17 percent below the pre-crisis level. There have been virtually no tourists from East Asia this summer.
The outlook for Switzerland remains bright. Companies are still optimistic. In addition, the high coronavirus case numbers haven't yet triggered a decline in economic activity.

USA

Growth, sentiment and trend
In percemt



Source: Bloomberg

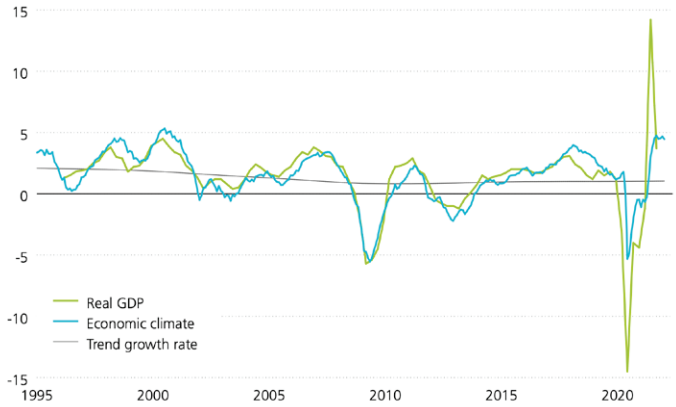
The US economy grew again in the third quarter by 0.5 percent, albeit at a slower pace than in the four previous quarters. While the economy is performing well, high inflation rates are an increasing cause of concern. Inflation hit 6.8 percent in November, its highest level in almost 40 years.

It may now have peaked, as oil and gas prices haven't risen again, and the supply of other scarce goods is expected to ease next year. Despite this, US inflation will remain at over 3 percent next year, as rents and wages are rising, which in turn is making services more expensive. (The US Federal Reserve has now announced plans to withdraw from its expansive monetary policy more quickly due to fears over inflation. The first interest rate hike may be made in the first half of 2022.)

Eurozone

Growth, sentiment and trend

In percemt



Source: Bloomberg

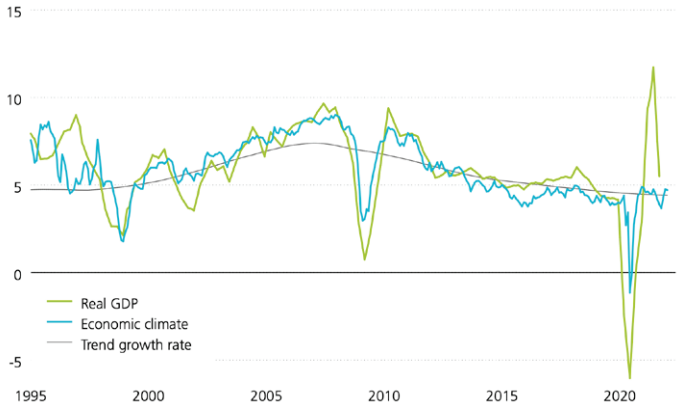
High case rates are currently causing economic setbacks once again in some European countries. In Austria, for example, value creation fell by an estimated 10 percent following the announcement of another lockdown. But these declines may prove temporary and do not change the general upward trend. The leading sentiment indicators have been at an historically high level since July.

Inflation also soared in the eurozone, recently hitting 4.9 percent, which is a 30-year high. The European Central Bank (ECB) has yet to announce a reversal of its expansive monetary policy. As inflation looks set to remain above the 2 percent target in the eurozone for a long period, however, the ECB may be forced to raise interest rates next year, despite previous communications.

Emerging markets

Growth, sentiment and trend

In percemt



Source: Bloomberg

China is now struggling to deal with coronavirus. In November, regional lockdowns were imposed in response to local outbreaks for the third time this year, and this has so far resulted each time in a fall in revenue in the services sector. It will also take China some time to recover from the insolvency of the real estate developer Evergrande. Evergrande represents the government's shift away from debt-driven growth, which has triggered a property boom over the past decade. China's economic weakness has had little impact on the global economy thus far, however, as Chinese foreign trade remains buoyant. Both exports and imports reached new record levels in November.

Global economic data

Indicator	Switzerland	USA	Eurozone	UK	Japan	India	Brazil	China
GDP Y/Y [1] 2021Q2	8.6%	12.2%	14.4%	23.6%	7.6%	20.1%	12.3%	7.9%
GDP Y/Y [1] 2021Q3	4.1%	4.9%	3.9%	6.6%	1.4%	8.4%	4.0%	4.9%
Economic climate [2]	→	↘	→	↘	↗	↘	↘	↗
Trend growth [3]	1.4%	1.6%	0.8%	1.7%	1.0%	5.1%	1.1%	4.1%
Inflation	1.5%	6.8%	4.9%	4.2%	0.1%	4.9%	10.7%	2.3%
Key rates	–0.75%	0.08%	0.00%	0.10%	–0.10%	4.00%	9.25%	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. Plus indicates an increasing economic growth, minus a slowing.
[3] Potential growth. Long-term change in gross domestic product with sustainable capacity utilization.

Source: Bloomberg

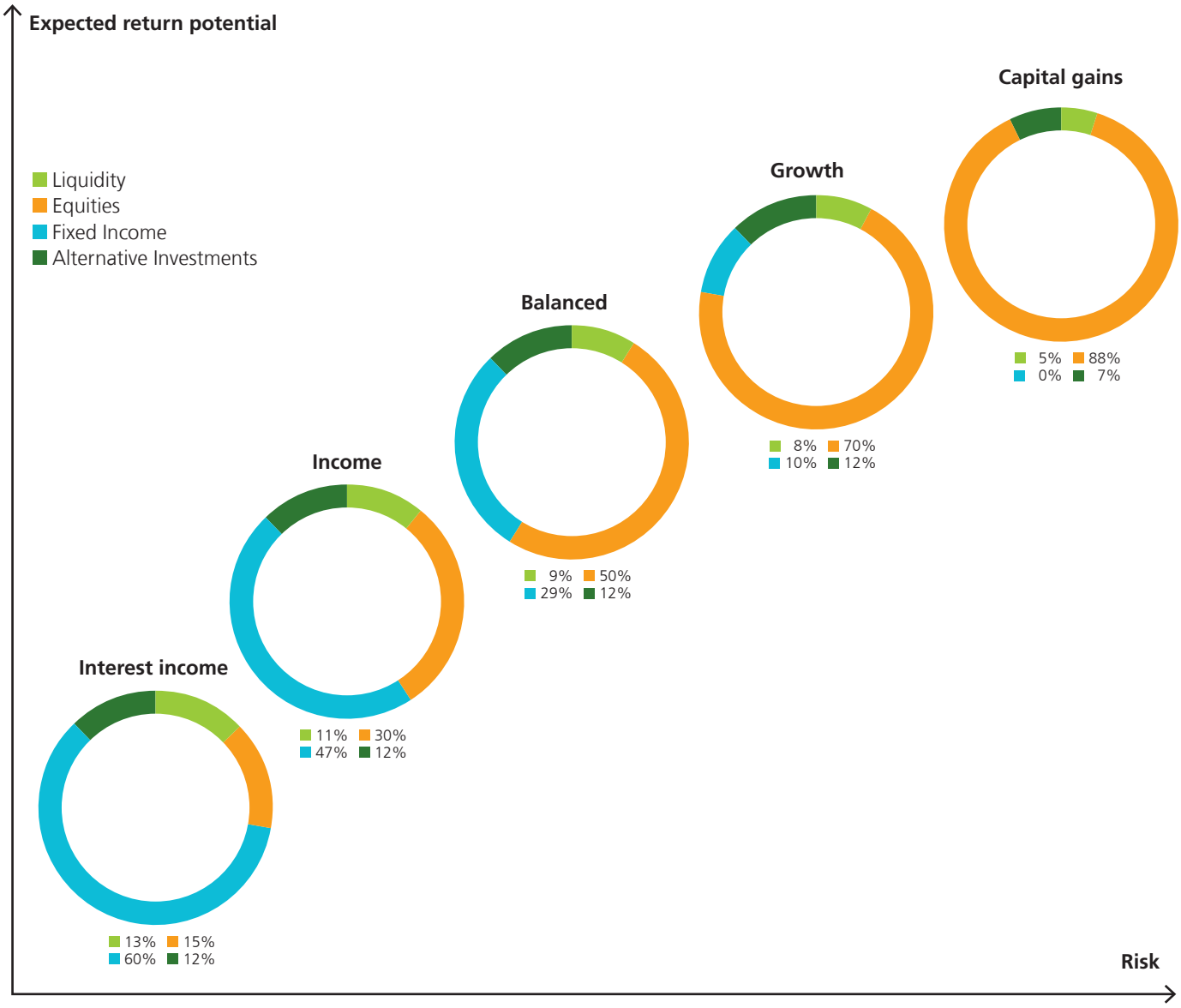
Model portfolios Swiss focus

American shares with low potential

The US central bank has less room for manoeuvre in monetary policy due to higher inflation. A more restrained monetary policy could have a negative impact on the US markets. The upside potential of US equities is thus limited in our view. The situation in Japan, on the other hand, is different: more economic catch-up potential, low inflation and a weak Japanese yen speak in favour of Japanese equities. Accordingly, we are reducing the risk in US equities and buying the Japanese equity market instead.

In Switzerland, credit spreads for companies with good credit quality are now above pre-Corona levels. This is likely to reflect concerns about the new virus variant. This creates a tactical opportunity: we recommend overweighting Swiss corporate bonds at the expense of global bonds.

Swiss real estate funds have corrected slightly in the last month. Nevertheless, the valuation is still above the fair level derived from long-term interest rates. However, it seems unlikely to us that the valuation will return to its fair value in the near future. We are therefore taking advantage of the recent correction and neutralising our underweight.



Source: PostFinance Ltd

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PostFinance Ltd
Mingerstrasse 20
3030 Berne

Phone +41 848 888 900

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