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PostFinance

Editorial

Equity markets in no man's land

The global economic outlook has deteriorated further, but equity markets seem to be refusing to accept it. Economic slowdown would have a moderating effect on the inflation and interest rate outlook. However, profit forecasts have still not been corrected. This is further reason for caution in our view.

Philipp Merkt
Chief Investment Officer

Performance on the equity markets has been abysmal over recent months. There's been a downward trend since the start of the year. Prices have mainly been forced down by concerns over the interest rate trend in the first half of the year. Many people have pushed it to the back of their minds due to the dreadful images coming out of Ukraine, but US inflation stood at 7.5 percent even before the Russian invasion. The US Federal Reserve has long been making overtures about reining in inflation – perhaps for too long. It has now raised money market rates by 1.5 percentage points to 1.75 percent. Further hikes look set to follow. But that's still not enough to really bring inflation under control.

Inflation-related income erosion and losses on investments for consumers are creating an even gloomier economic picture. In real terms, the purchasing power of US households has been eroded significantly this year. So it's little wonder that consumer confidence has plummeted to its lowest level since records began 70 years ago. The situation is now being exacerbated by the fact that higher interest rates are starting to impact on the construction industry. It will probably take just two or three months before the labour market begins to falter. In all likelihood, this will halt the inflation trend, but it will also deal another blow to consumers.

So far, the equity markets appear largely unperturbed by all of this. Equity analysts have been predicting for months that corporate profits will continue to grow at between 8 and 9 percent over the coming 12 months. There are of course a few voices expressing fears over recession. But this prospect doesn't appear to have dawned on the wider market.

The lack of reaction from analysts is not entirely beyond comprehension. Sentiment in business is not yet as bad as amongst consumers. But it's hard to imagine that this will remain the case: in the survey of companies in US industry on expected order intake, more firms expected orders to fall rather than rise in June, the first time this has happened since the coronavirus crisis.

"For as long as the markets continue to believe in strong profit growth rates, scepticism over prices is justified."

At the moment, the market is still hoping that inflation and interest rates will simply come to a standstill, halting the negative equity price performance in the first half of the year. However, market participants still refuse to accept that the reason for this is a major economic cooldown. The equity market is currently in a no man's land of expectation. Until the R-word (recession) becomes a generally accepted reality, we will continue to adopt a cautious approach towards equities, while remaining aware that they will need to be purchased again rapidly when the recession bottoms out. But we haven't reached that point yet.

Positioning

Signs of a weak economy

There were growing indications of a shift towards recession last month. Falling raw material prices and rising risk premiums on corporate bonds are signifiers of a weak economy. It seems that only equity markets are still refusing to fully reflect the situation.

Perhaps the most striking development last month was the sharp decline in raw material prices. Prices for industrial metals, energy and grain tumbled by up to 20 percent. The only notable exception was European gas prices, which reflected concerns over the continued closure of the Nord Stream 1 pipeline by Russia. Month-on-month, they have still risen by over 30 percent. However, raw material investments were last month's biggest loser in overall terms.

"A global recession now appears highly likely. It seems that only equity markets are still refusing to fully accept the situation."

At the same time, the risk premiums on corporate bonds have soared due to lower growth forecasts, while government bonds have ceded some of the previous month's interest rate rise. Overall, the impression is emerging that the financial markets are only now starting to reflect growing fears over the state of the economy. News of China's growth slowing down significantly in the second quarter provided a rude awakening for market participants. The sentiment indicators for business also continued falling in the industrial nations. Coupled with consumer sentiment, which already lies at recession level in almost all of these countries, the economic picture looks increasingly gloomy.

Performance of asset classes

Asset class		1M in CHF	YTD [1] in CHF	1M in LCY [2]	YTD [1] in LCY [2]
Currencies	EUR	–5.5%	–5.0%	–5.5%	–5.0%
	USD	–1.8%	7.7%	–1.8%	7.7%
	JPY	–4.2%	–10.7%	–4.2%	–10.7%
Equities	Switzerland	1.2%	–15.3%	1.2%	–15.3%
	World	–1.9%	–15.2%	–0.1%	–21.3%
	USA	–0.2%	–15.0%	1.6%	–21.1%
	Eurozone	–7.7%	–23.6%	–2.3%	–19.6%
	United Kingdom	–5.0%	–5.8%	–1.9%	–0.1%
	Japan	–3.4%	–14.8%	0.8%	–4.7%
	Emerging markets	–6.1%	–14.1%	–4.4%	–20.3%
Fixed Income	Switzerland	3.1%	–9.4%	3.1%	–9.4%
	World	–1.0%	–8.3%	0.8%	–14.9%
	Emerging markets	–5.2%	–16.9%	–3.5%	–22.9%
Alternative Investments	Swiss real estate	1.1%	–13.4%	1.1%	–13.4%
	Gold	–8.1%	1.5%	–6.5%	–5.8%

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

Data as of 14.07.2022
Source: Web Financial Group, MSCI, SIX, Bloomberg Barclays, J.P.Morgan

Central banks facing a dilemma

The significant economic cooldown is making the central banks' task of controlling inflation much harder. The major central bankers are still spouting rhetoric about tackling inflation. However, an impending global recession may force measures aimed at bringing inflation under control to be abandoned before they have even really begun. The upshot may be fewer interest rate hikes than the markets previously feared. But this also means that actively combating structurally higher inflation may not be politically feasible in the short term. Inflation rates would then establish themselves at a higher level than before the crisis, which could also result in higher interest rates over the medium term. In light of these developments, we're maintaining our cautious approach on the bond markets, despite the risk of recession.

Equity market in precarious position

The equity market seems reluctant to accept the prospect of the growth outlook worsening. For months now, business analysts have continued forecasting healthy profit growth for private limited companies. The fact that the momentum of the profit trend clearly appears to have ground to a halt quarter-on-quarter makes this all the more remarkable. In our view, market participant forecasts will have to adapt to a slump in corporate profits sooner or later. Monetary policy – due to its own rhetoric and inflation, which is still much too high – is unable to act firmly enough to avert a recession. This is why we are reducing our equity allocation in the USA once again.

We are also retaining our underweighted position in European equities. In light of the ongoing energy supply crisis, we anticipate much weaker economic indicators in Europe, following the slowdown of growth in the USA.

Gold and real estate remain steady

Even though the gold price has been disappointing in recent weeks, we still recommend keeping an overweighted gold position in the portfolio. In times of disconcertingly high inflation and weak equity and bond markets, gold and real estate are providing stability in our portfolios.

Positioning relative to long term strategy: Swiss focus

Asset class		TAA[1] old	TAA[1] new	underweighted[3] ––	–	neutral[3]	+	overweighted[3] ++
Liquidity	**Total**	**13.0%**	**15.0%**					
	CHF	13.0%	15.0%					
Equities	**Total**	**46.0%**	**44.0%**					
	Switzerland	23.0%	23.0%					
	USA	8.0%	6.0%					
	Eurozone	3.0%	3.0%					
	United Kingdom	2.0%	2.0%					
	Japan	2.0%	2.0%					
	Emerging markets	8.0%	8.0%					
Fixed Income	**Total**	**27.0%**	**27.0%**					
	Switzerland	15.0%	15.0%					
	World[2]	6.0%	6.0%					
	Emerging markets[2]	6.0%	6.0%					
Alternative Investments	**Total**	**14.0%**	**14.0%**					
	Swiss real estate	7.0%	7.0%					
	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
Equities

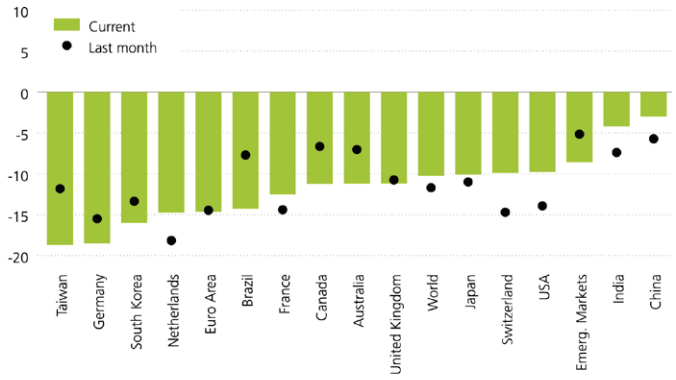
The global equity markets suffered heavy losses during the first half of the year. The start to the second half-year was also overshadowed by growing fears of recession.

Indexed stock market performance in Swiss francs
100 = 01.01.2022

The global equity markets fell almost in sync. They tumbled once again last month, and recovery in July was very sluggish. The global economic outlook is now very gloomy. The situation is already overwrought due to the strong inflation trend and the measures being taken by central banks to bring it under control. Global and Swiss equities have tumbled by –15 percent since year-opening measured in Swiss francs, while their emerging-market counterparts have fared slightly better, falling by –13 percent.

Source: SIX, MSCI

Momentum of individual markets
In percent



Less surprising, in light of fears of recession worldwide, is the strong negative momentum on the equity markets, including at country level. Taiwan and Germany are performing most poorly. While there are still concerns over Chinese claims to power in Taiwan, Germany is being hit particularly hard by the European energy crisis due to its heavy reliance on Russian gas imports. There was a slight improvement in the trend in India and China recently.

Source: MSCI

Price/earnings ratio
P/E ratio

The price slump on the equity markets has triggered a significant decline in the price/earnings ratio (P/E ratio) since the start of the year. Whereas Swiss equity prices equated on average to 25 times company profit a year ago, this ratio has now been cut to 15 times. Compared to periods of recession in the past, however, the current valuation levels are still high.

Source: SIX, MSCI

Market overview
Fixed income

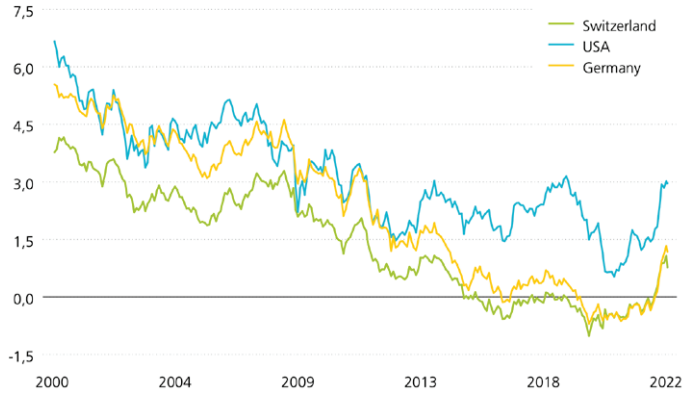
There were turbulent conditions on the capital markets last month. The worsening economic outlook is increasingly being factored in.

Indexed performance of government bonds in Swiss francs
100 = 01.01.2022

The ups and downs on the bond markets continued last month. After government bonds suffered heavy losses during the first half of June in particular – Swiss securities with a 10-year term briefly fell by around 16 percent – a strong recovery followed, reducing losses by 5 percent. The performance of German 10-year government bonds followed a very similar pattern, with losses now standing at 14 percent since year-opening. US government bonds performed significantly better from the perspective of Swiss investors, as losses of just 2 percent have been recorded since year-opening. However, this is largely due to the exchange rate.

Source: SIX, Bloomberg Barclays

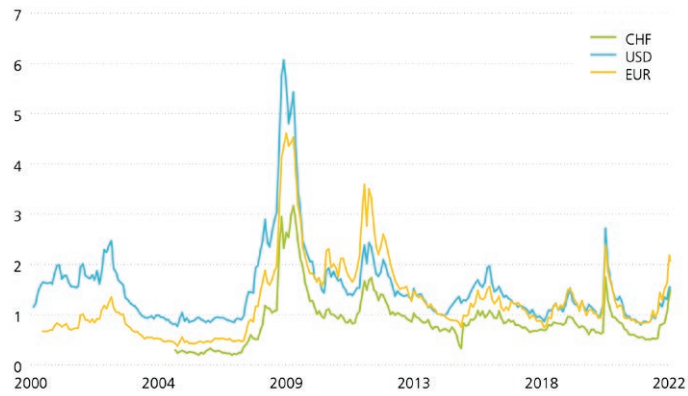
Trend in 10-year yields to maturity
In percent



Interest rates on the capital markets rose rapidly during the first half-year. By contrast, last month was something of a rollercoaster ride. Yields to maturity on 10-year US government bonds – a key benchmark for investors – climbed from 2.9 percent at the end of May to 3.5 percent in mid-June, before slipping back to the level seen at the end of May once again in early July. The publication of the May inflation rate for the USA, which stood at 8.6 percent, was clearly a factor in the June increase. The situation has since eased again, despite surprisingly high inflation of 9.1 percent in June. The yields to maturity on Swiss government bonds also experienced a remarkable series of ups and downs, but they climbed out of negative figures during the first half-year – reaching 1.5 percent at one point – and still remain well within positive territory.

Source: SIX, Bloomberg Barclays

Credit spreads on corporate bonds
In percentage points



The broad realization of the possibility of a forthcoming recession is also apparent on the corporate bond markets. Investors were once again much more risk-averse last month. As a result, the risk premiums being demanded rose sharply – making the default risk on corporate bonds much higher than on their government counterparts. This is particularly having an effect on European securities, which are being hit not just by fears of recession, but also by the emerging energy crisis. A risk premium of over 2 percent on average is currently being demanded. In contrast, Swiss corporate bonds are deemed just as secure as their US counterparts. The spread currently stands at 1.5 percent.

Source: Bloomberg Barclays

Market overview

Swiss real estate investments

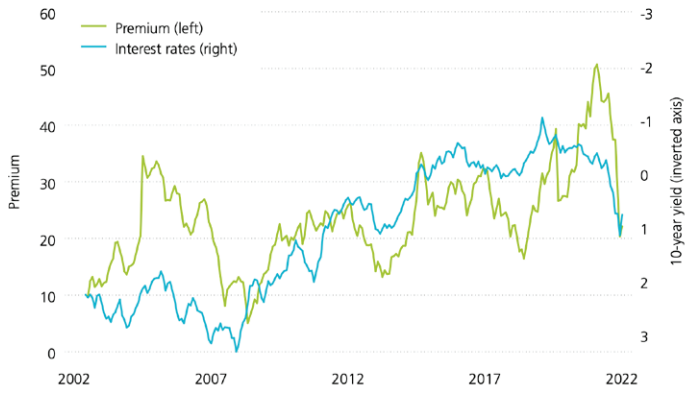
Real estate investments have also undergone significant market fluctuations recently. Swiss real estate funds still posted a positive result month-on-month, however.

Indexed performance of Swiss real estate funds
100 = 01.01.2022

Listed Swiss real estate investments were also unable to escape the turbulent conditions on the financial markets last month. This was mainly due to the sharp fluctuations in interest rates. However, price losses since the start of the year – measured in Swiss francs – were reduced from –17 to –13 percent month-on-month.

Source: SIX

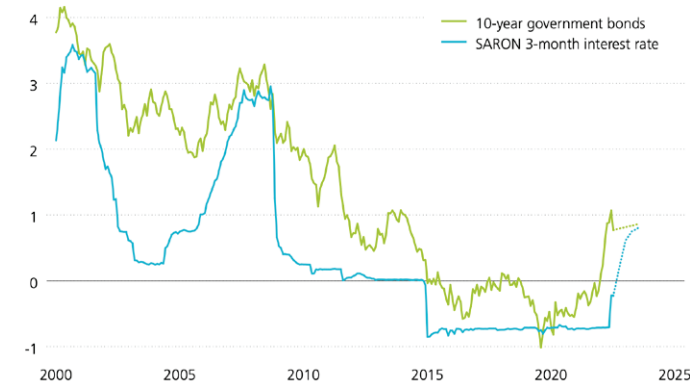
Premium on Swiss real estate funds and 10-year yields to maturity
In percent



There has been a clear upward trend in premiums on Swiss real estate funds over the past decade, peaking at 50 percent on average last summer, measured by the value of the properties contained in the funds. There has since been a sharp decline, with premiums more than halving. Considering the current level of interest rates, listed Swiss real estate investments are now fairly valued again.

Source: SIX

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



There has been a strong rise in 10-year yields to maturity on Swiss government bonds since the start of the year. After announcing plans to rein in inflation and an initial interest rate hike, the Swiss National Bank raised the Swiss reference interest rate SARON. This also makes short-term lending from banks and financial institutions more expensive.

Source: SIX

Market overview

Currencies

The US dollar is currently soaring high. There was also stronger demand for the Swiss franc as a safe-haven currency recently. By contrast, the European currencies and the Brazilian real suffered heavy losses.

The deteriorating economic outlook is also reflected on the currency markets. The US dollar – which is also the global reserve currency – continued its surge of recent months. Measured by a basket of currencies (dollar index), the increase since year-opening stands at almost 17 percent. The Swiss franc has also performed strongly recently. It may have benefited from the Swiss National Bank's firm statement on tackling inflation. The euro is currently affected particularly strongly due to geopolitical tensions and the energy crisis. The euro reached parity with the US dollar for the first time in 20 years. The Norwegian krone and Swedish krona also suffered losses. The fall in the value of the Brazilian real typifies the emerging market currencies – with the exception of the Chinese renminbi. These countries are being hit by the current strength of the US dollar.

Currency pair	Price	PPP [1]	Neutral area [2]	Valuation
EUR/CHF	0.99	0.86	0.80–0.93	Euro overvalued
USD/CHF	0.98	0.75	0.66–0.85	USD overvalued
GBP/CHF	1.16	1.27	1.09–1.44	Pound neutral
JPY/CHF	0.71	0.98	0.82–1.13	Yen undervalued
SEK/CHF	9.27	9.26	8.37–10.15	Krona neutral
NOK/CHF	9.61	10.68	9.54–11.82	Krona neutral
EUR/USD	1.00	1.15	1.00–1.30	Euro neutral
USD/JPY	138.99	77.00	62.23–91.77	Yen undervalued
USD/CNY	6.76	5.59	5.33–5.84	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 dipping to almost 1,700 US dollars.

Indexed performance of gold in Swiss francs
100 = 01.01.2022

The precious metal performed remarkably well in the turbulent first half of the year. While most asset classes recorded considerable losses, gold was down by only 1.2 percent measured in US dollars and was actually up 3.4 percent measured in Swiss francs. But the gold price weakened last month. In March, the price per troy ounce reached 2,050 US dollars, but it is now approaching the 1,700-dollar mark again. This is explained by growing fears over recession worldwide, as well as the strong dollar and rising interest rates. These factors are overshadowing inflationary concerns, despite the persisting high trend.

Source: Web Financial Group

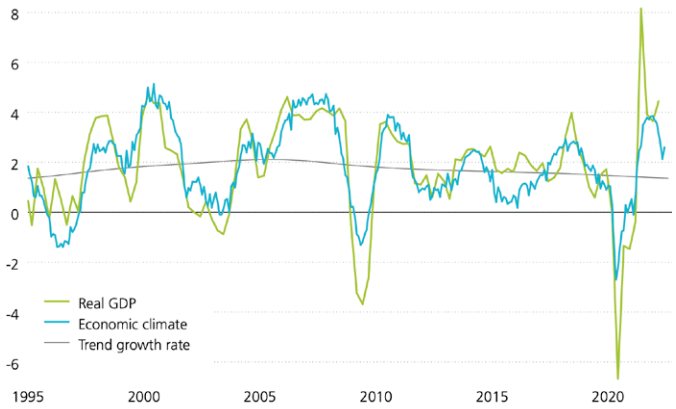
Economy

Global recession ever more likely

Optimism is increasingly turning into pessimism – not only among consumers, but now also among companies. Only the Swiss economy seems to be lagging behind in this development.

Switzerland

Growth, sentiment and trend
In percent

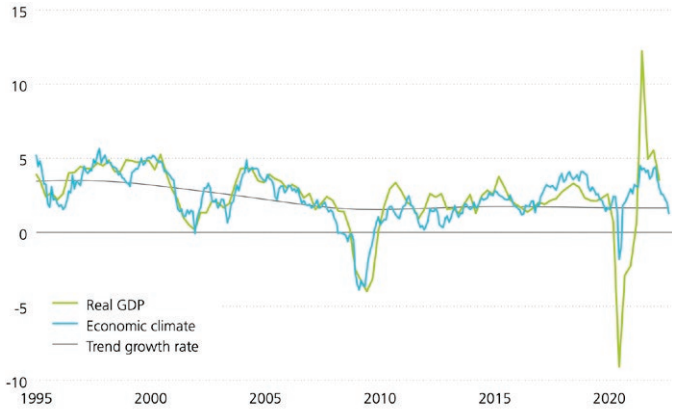


Source: Bloomberg

The Swiss economy is faring better than its European counterparts. This may partially be explained by the fact that Switzerland seems to be lagging behind developments in Europe by around three months, both in terms of the upturn after the pandemic and the current slowdown in growth. Paradoxically, the exchange rate is probably also responsible for the better performance we are seeing at the moment. Firstly, raw material imports are benefiting from the slightly stronger Swiss franc, and secondly, the franc has appreciated less than the inflation differential with countries abroad for tradable goods. This has boosted the competitiveness of Swiss exporters. However, this advantage could be wiped out over time if the franc continues to appreciate.

USA

Growth, sentiment and trend
In percent

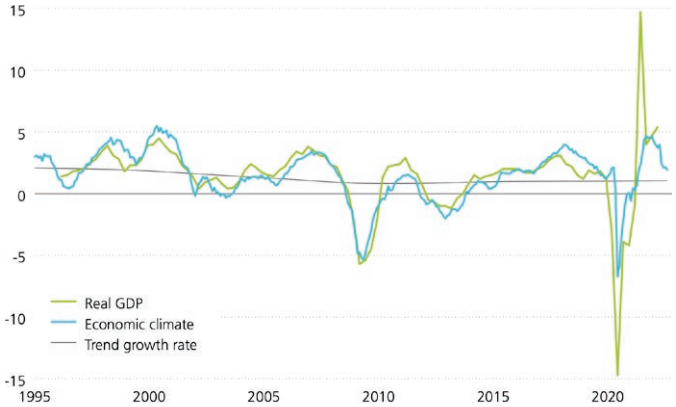


Source: Bloomberg

On the other side of the Atlantic, business sentiment has deteriorated further. After consumer confidence hit an all-time low a month ago, purchasing managers in industry were also considerably less optimistic this month. While the level of orders booked remains strong, there is great concern over future order intake. Consumer price inflation also hit a new high, reaching 9.1 percent in June. Even though household spending nominally rose once again, it is now falling in real terms. The second quarter growth figures set to be announced at the end of the month are being awaited with great anticipation. Current indications suggest the figures will prove disappointing again, after negative growth in the first quarter.

Eurozone

Growth, sentiment and trend
In percent

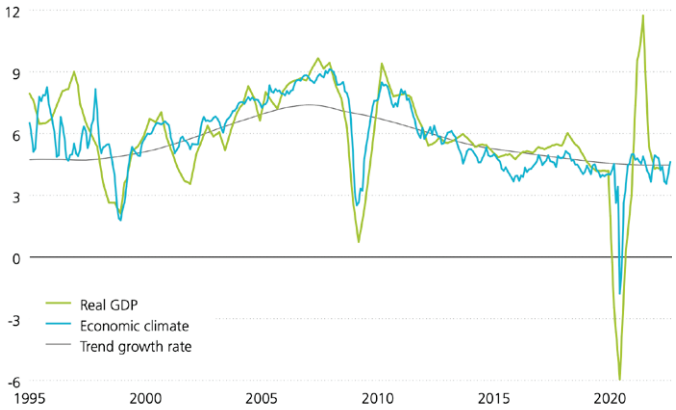


Source: Bloomberg

There has now been a sharp cooldown in business sentiment in the eurozone. With inflation rates at an average of 8.6 percent in June, already faltering consumer confidence deteriorated further. The current debate over how Europe will fare in terms of gas supply over the winter months has probably done little to change the situation. Core inflation in Europe still remains well below that in the USA, reducing the need for action from the ECB, which has been extremely reluctant to intervene thus far. However, Italy's recent governmental crisis shows that there are major political risks as well as economic ones in the eurozone.

Emerging markets

Growth, sentiment and trend
In percent



Source: Bloomberg

China once again attracted the greatest interest amongst the emerging markets. After the Chinese economy slumped dramatically following the draconian measures imposed by the government in April and May, the first signs of stabilization emerged in June. Growth in the second quarter proved very disappointing, however – at –2.6 percent, there was an annual growth rate of just 0.4 percent. There is greater optimism for the current quarter, owing to state economic stimulation measures. But for as long as strict lockdown measures are used to tackle coronavirus, the Chinese economy cannot be expected to provide any economic impetus for the rest of the world.

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%	0.4%	4.1%	1.7%	4.8%
GDP Y/Y [1] 2022Q2	–	–	–	–	–	–	–	0.4%
Economic climate [2]	↘	↘	↘	↘	↗	→	↘	→
Trend growth [3]	1.4%	1.6%	0.8%	1.7%	1.1%	5.1%	1.2%	4.0%
Inflation	3.4%	9.1%	8.6%	9.1%	2.5%	7.0%	11.9%	2.5%
Key rates	–0.25%	1.75%	0.00%	1.25%	–0.10%	4.90%	13.25%	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. 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

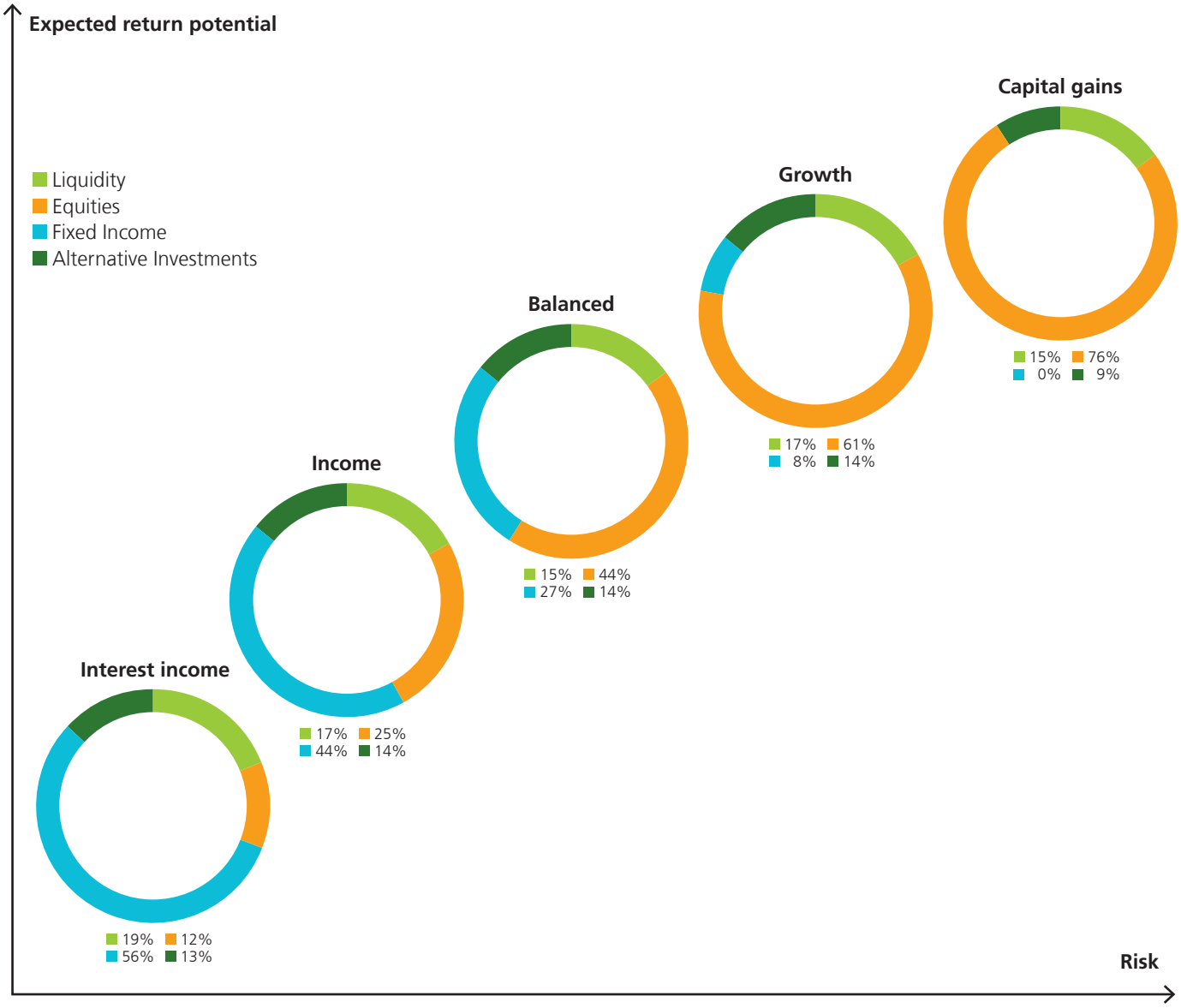
Model portfolios Swiss focus

Recession risk increases: Equities further reduced

The mood among companies and consumers is now so pessimistic that a recession has become quite likely, at least in the USA. In view of the consequences of the Russian war of aggression in Europe, it is also to be expected that the European economy will be severely damaged. Even if inflation should now have peaked in the short term, it remains uncomfortably high, so central banks cannot ignore it. However, falling growth expectations and rising interest rates are poison for the financial markets.

So far, on the financial analyst side, earnings estimates do not reflect the economic slowdown, so we remain very cautious on the equity market. This month, we recommend to increase the underweight in US equities once again. Given the persistently high core inflation rates, we continue to find long-dated government bonds unattractive. We therefore confirm our underweight in bonds.

Gold and real estate continue to act as stabilisers in our portfolio. We are aware that there is potential for a setback here as well, but we consider this significantly smaller than in the case of equities and bonds.



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