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Editorial

Financial markets hit by rising interest rates

Since year-opening, interest rates on the capital markets have risen more sharply than for decades. The immediate result has been tumbling prices for investors. Rising inflation now seems to have peaked, which should bring the interest rate trend to a halt.

Philipp Merkt
Chief Investment Officer

2022 has proven a challenging year for investors so far. A look at the performance of the major asset classes reveals where the problem lies: prices have tumbled across the board – whether bonds, equities or real estate. Even the price of supposedly secure gold is lower than a few months ago. As a result, almost all investors are experiencing similarly poor performance: even those who opted for a restrained investment strategy with a low equity component lost almost as much as investors with greater risk appetite.

This development is due to the unexpectedly strong rise in inflation. The triggers for all this are well documented: the Ukraine conflict, higher commodity prices and supply bottlenecks. Inflation has dragged capital market interest rates up in its wake. Whereas ten-year Swiss government bonds were still generating negative yield on maturity a year ago, the return now stands at almost 1 percent. However, rising interest rates inevitably lead to lower bond prices and are toxic for the valuation of equities and real estate.

Fortunately, the inflation trend seems to be close to peaking for the time being in the USA. This is partly due to the US economy losing some growth momentum. But it's also down to a simple basic effect: compared to the previous quarter, oil and gas prices have remained high, but have not risen sharply. Aside from this inflationary trend, which appears to have been broken, the US Federal Reserve is now tackling inflation – better late than never.

In Switzerland, as elsewhere in Europe, economic development and monetary policy are lagging behind the US. This suggests that the key rates will shortly be raised and sounds a note of caution about Swiss franc bonds. However, it is not beyond the realms of possibility that a reversal in US inflation could also have a restraining effect on interest rate hikes here in Switzerland.

Some commentators are already anticipating that capital market interest rates will fall again, based on greater recession risks over recent months. This is premature, in our view. Even though most economists are still not forecasting a recession, this validates our general sense of caution. Showing restraint towards equities and bonds – as in previous months – remains advisable for the time being.

"A cautious approach is advised!"

But we have no doubt that most asset classes will bounce back in the long term, despite a difficult start to the year. Investment profiles differentiated by risk appetite will soon also start generating varying yields again. Equities still enjoy the benefit that companies pay dividends when they turn a profit. Real estate generates rental income. As soon as the stress of the current interest rate rises eases, risk premiums on these asset classes can also be expected once again.

Positioning

Financial markets in the wake of interest rate hikes

Central banks remain under pressure to act, even though inflation rates may have peaked for the time being in the USA and Europe. The Swiss National Bank is also coming under greater pressure. We are increasing our underweighted position in the bond allocation and are reducing Swiss bonds.

Interest rates have risen sharply worldwide since the start of the year in response to persisting inflationary pressure. While inflation rates may have peaked in the USA and Europe, inflationary pressure remains high, forcing central banks to act. The US Federal Reserve (Fed) recently stepped up its policy to rein in high inflation. At its last meeting in early May, it agreed to raise interest by 0.5 percent and announced plans to make further similar hikes and to begin reducing the size of its balance sheet from June. The Fed accepts that this may trigger an economic slowdown.

Statements by representatives of the European Central Bank (ECB) suggest that it's more a question of when rather than if interest rates are raised. This may come as soon as July. Although inflation rates are lower in Switzerland, pressure is mounting here, too. The Swiss National Bank (SNB) will have to contemplate an initial interest rate rise at its next review meeting in mid-June. Raising interest rates would boost the SNB's credibility, especially since negative interest rates are no longer justified given the Swiss franc's current weakness. For this reason, we recommend increasing the underweighted position in bonds by reducing the Swiss bond allocation. Otherwise, we are maintaining our defensive portfolio alignment.

Performance of asset classes

Asset class		1M in CHF	YTD [1] in CHF	1M in LCY [2]	YTD [1] in LCY [2]
Currencies	EUR	3.1%	0.4%	3.1%	0.4%
	USD	7.5%	9.9%	7.5%	9.9%
	JPY	5.0%	–1.4%	5.0%	–1.4%
Equities	Switzerland	–6.7%	–10.1%	–6.7%	–10.1%
	World	–3.9%	–9.7%	–10.6%	–17.8%
	USA	–4.5%	–10.4%	–11.2%	–18.4%
	Eurozone	–1.7%	–14.5%	–4.7%	–14.8%
	United Kingdom	–3.0%	1.1%	–3.9%	1.8%
	Japan	2.8%	–9.1%	–2.1%	–7.9%
	Emerging markets	–4.2%	–11.4%	–10.9%	–19.3%
Fixed Income	Switzerland	0.6%	–7.0%	0.6%	–7.0%
	World	3.8%	–3.1%	–3.4%	–11.8%
	Emerging markets	2.3%	–8.9%	–4.9%	–17.1%
Alternative Investments	Swiss real estate	–8.7%	–9.4%	–8.7%	–9.4%
	Gold	0.7%	11.8%	–6.3%	1.7%

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

Data as of 12.05.2022
Source: Web Financial Group, MSCI, SIX, Bloomberg Barclays, J.P.Morgan

Sharp downturn on equity markets

The recovery of the equity market in the previous month proved only temporary. The rapid rise in interest rates in April led to widespread losses on equities last month. US and emerging market equities suffered the severest downturn. While the Fed's efforts to rein in inflation have created headwind for US equities, emerging market equities have been hit by the strong US dollar and a faltering China. By contrast, European equities lost less ground. In light of the great pressure on the ECB to act and the as yet unresolved Ukraine conflict, we're maintaining our underweighted position in European equities.

"An interest rate rise in June would boost the SNB's credibility."

US dollar soars

The US dollar triggered even greater unease on the financial markets. Adjusted for purchasing power, the US currency has not been so heavily overvalued for 40 years. The Japanese yen – another "safe haven" currency – has also been making gains again for some time. The Swiss franc, on the other hand, weakened significantly. It's trading at over 1.04 against the euro once again and has now reached parity against the US dollar. But that's not bad news for a Swiss franc portfolio: losses on equity markets abroad have been significantly reduced by the franc's weakness.

Gold weakens

Gold took a hit last month, despite continuing to provide a good diversification option. The price of a troy ounce of the precious metal now stands at just over 1,800 US dollars. A month ago, it was still above the mark of 1,920 US dollars. Considering that interest rates as opportunity costs and the US dollar have risen so sharply, the gold price is still faring remarkably well. However, gold has further upturn potential in the current anxious environment, which is why we're retaining our overweighted position in gold.

Positioning relative to long term strategy: Swiss focus

Asset class		TAA[1] old	TAA[1] new	underweighted[3] ––	–	neutral[3]	+	overweighted[3] ++
Liquidity	**Total**	**9.0%**	**11.0%**					
	CHF	9.0%	11.0%					
Equities	**Total**	**48.0%**	**48.0%**					
	Switzerland	23.0%	23.0%					
	USA	10.0%	10.0%					
	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**	**29.0%**	**27.0%**					
	Switzerland	17.0%	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%					

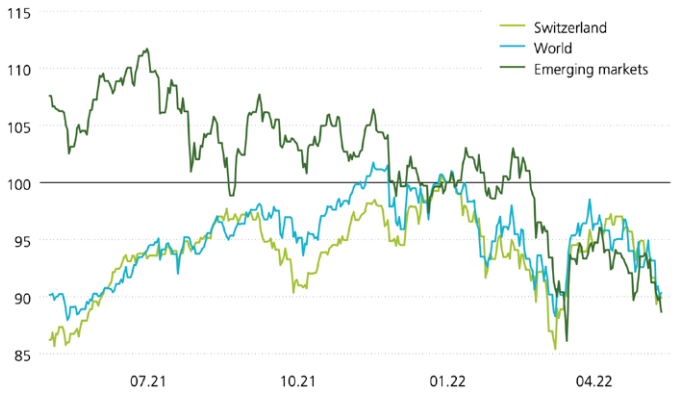
[1] Tactical Asset Allocation: short to mid-term orientation
[2] Currency hedge to CHF
[3] Positioning relative to our long-term asset allocation

— Adjustment compared to last month

Market overview
Equities

Rising interest rates and continuing inflation produced headwind on the equity markets. Significant price losses were recorded last month.

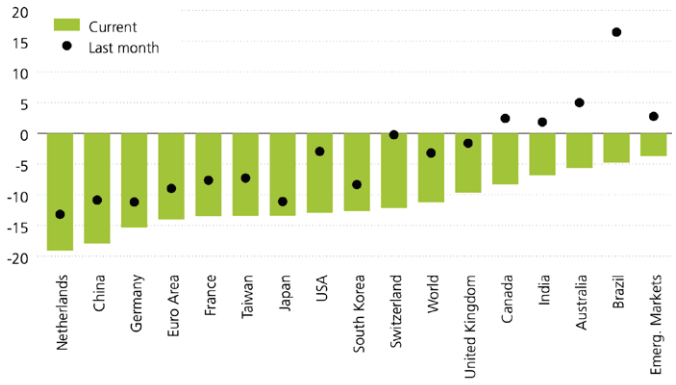
Indexed stock market performance in Swiss francs
100 = 01.01.2022



For a short time, it looked as though the equity markets had left the losses from the start of the Ukraine conflict behind them. But the measures introduced by central banks to combat inflation triggered another major downturn last month. Losses since year-opening stand at around 10 percent. Technology stocks have been particularly badly hit. They had made significant gains even during the coronavirus crisis.

Source: SIX, MSCI

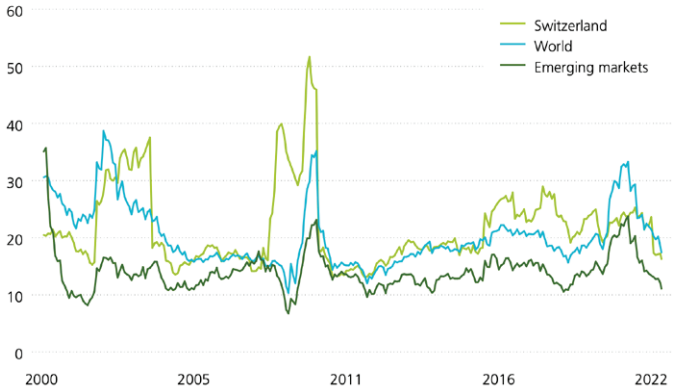
Momentum of individual markets
In percent



The strong downward trend – driven by concerns over inflation and the economy – left no country untouched last month. The Dutch equity market was particularly severely hit by negative momentum, after its technology heavyweights suffered major losses last month. The situation on the Chinese equity market also deteriorated. This was due to concerns over the impact of tight coronavirus restrictions – around 200 million people in the cities of Beijing and Shanghai are currently in lockdown.

Source: MSCI

Price/earnings ratio
P/E ratio



In light of the current high inflation trend and uncertain economic outlook, the potential for further corporate profit growth has been exhausted for the time being. Strong growth had been achieved over the past two years, resulting in a considerable decline in the price/earnings ratio (P/E ratio), despite high equity prices. The average P/E ratio for a Swiss company currently stands at 15, which means that the equity price is 15 times higher than profit.

Source: SIX, MSCI

Market overview

Fixed income

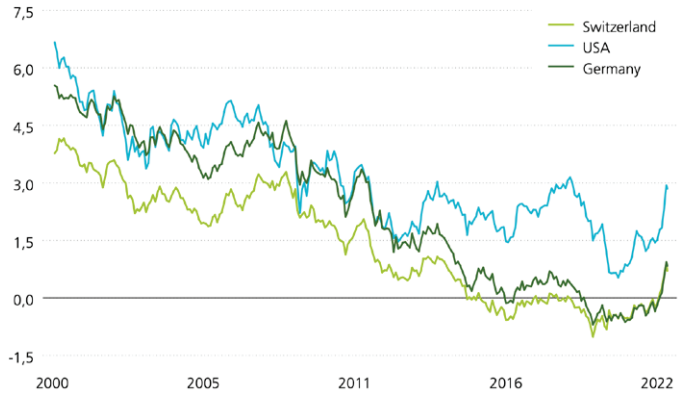
Due to the rapid hike in interest rates, the value of portfolios containing government bonds in industrial countries has fallen by 5 to 10 percent since year-opening. Concerns over the economy have curbed interest rate rises of late.

Indexed performance of government bonds in Swiss francs
100 = 01.01.2022

The bond markets are amongst the major losers this year, due to the tighter policy adopted by the US Federal Reserve. By raising interest rates by 0.5 percent for a second time, it is increasingly focusing on reining in inflation. Two further similar interest rate hikes are expected in June and July. The Federal Reserve also looks set to start reducing the size of its balance sheet from June. In light of the slowdown in economic growth, however, the rise in interest rates has levelled off somewhat recently. Due to the weakness of the Swiss franc against the US dollar, the losses on US government bonds had less impact on Swiss portfolios that had not hedged against foreign currency risks.

Source: SIX, Bloomberg Barclays

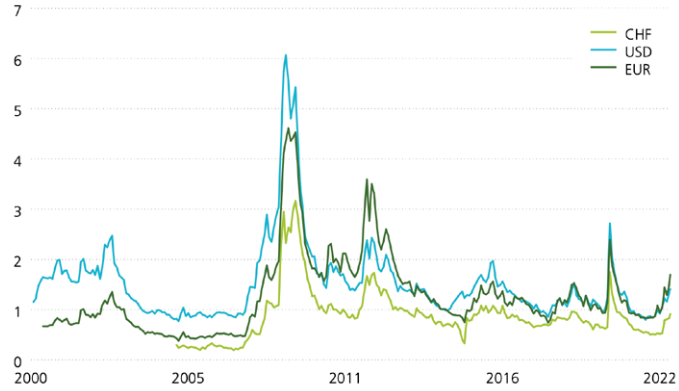
Trend in 10-year yields to maturity
In percent



The yields to maturity on government bonds rose once again last month. 10-year US government bonds broke through the 3-percent barrier. The last time they reached this level was in 2018. A similar trend also emerged in Europe. Swiss federal government bonds with a 10-year term recently reached a yield to maturity of 1 percent, while their German counterparts climbed as high as 1.2 percent. This means that the cost of borrowing has increased significantly.

Source: SIX, Bloomberg Barclays

Credit spreads on corporate bonds
In percentage points



Increased risk aversion among investors due to the threat from inflation and greater economic pitfalls is also being clearly reflected on the corporate bond market. As they present a greater default risk than government-issued bonds, a risk premium is factored in. In times of greater uncertainty, this credit spread is usually wider, whereas the credit spreads being demanded narrow during calmer times, due to the risk appetite among investors. Credit spreads have widened significantly again recently. The spread on corporate bonds issued in euros and US dollars currently stands at over 1.5 percentage points once again. Swiss corporate bonds are deemed even more secure, with the spreads at just under 1 percentage point.

Source: Bloomberg Barclays

Market overview

Swiss real estate investments

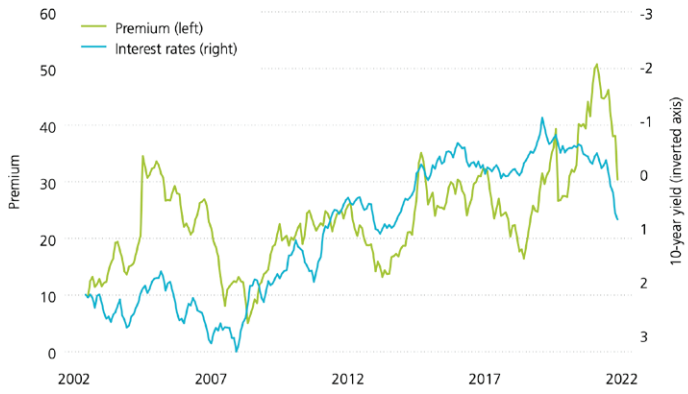
Real estate investments were hit by rising interest rates last month, and their price dropped sharply.

Indexed performance of Swiss real estate funds
100 = 01.01.2022

Listed Swiss real estate funds were particularly severely hit by last month's sell-off. One reason may be that interest rate hikes have made employee benefits institutions and other institutional investors regard government bonds once again as a more attractive asset class compared to real estate funds. Government bonds are now also yielding a positive return again in Switzerland, leading to a decline in willingness to pay for Swiss real estate funds. Their value tumbled by around 5 percent last month and has declined by 8 percent since the start of the year.

Source: SIX

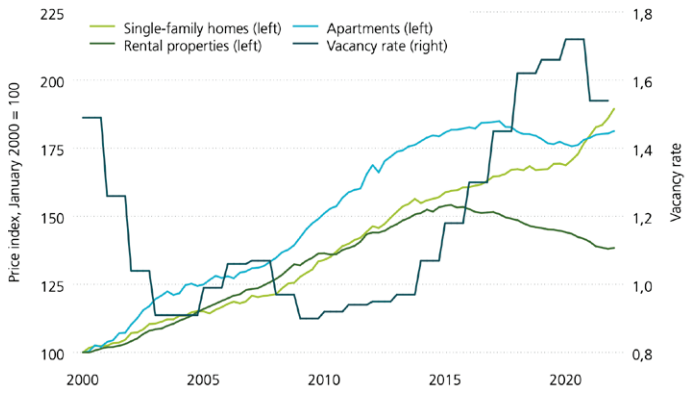
Premium on Swiss real estate funds and 10-year yields to maturity
In percent



In times of low interest in particular, investors are willing to pay a premium on the value of the properties contained in the fund. These premiums hit a record high of 50 percent last summer. Following market developments last month, however, premiums have plummeted and currently stand at just over 30 percent. This means that the valuation of Swiss real estate funds remains expensive despite the recent correction, as the current interest rate level would justify a premium of only around 25 percent.

Source: SIX

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



Higher interest rates are also making it more expensive to finance property purchases. On a Swiss fixed-rate mortgage with a five-year term, the interest rate has almost doubled from just over 1 percent last year to 2 percent now. Only short-term Saron mortgages, where the interest rate fluctuates on a daily basis, have so far remained at a low level. Fixed-rate mortgages are a more popular option in Switzerland – they predominate over Saron mortgages, with a share of over 80 percent.

Source: SNB, SFSO

Market overview

Currencies

The US dollar is making up ground. The Swiss franc and Japanese yen were surprisingly weak, however.

The US dollar is currently heading in only one direction – and that's up. Compared to a basket of currencies, the price of the US dollar reached its highest level for 20 years. Considering the great economic uncertainty over the outlook for the future, it's hardly surprising that investors are seeking refuge in the global reserve currency. The two other "safe havens" – the Swiss franc and Japanese yen – fared poorly in recent times, however. The previously strong currencies of the commodity-exporting countries of Canada, Australia and Norway also had the wind knocked out of their sails last month.

Currency pair	Price	PPP [1]	Neutral area [2]	Valuation
EUR/CHF	1.04	0.88	0.81 – 0.94	Euro overvalued
USD/CHF	1.00	0.77	0.68 – 0.87	USD overvalued
GBP/CHF	1.22	1.31	1.13 – 1.49	Pound neutral
JPY/CHF	0.78	0.98	0.83 – 1.14	Yen undervalued
SEK/CHF	9.88	10.05	9.09 – 11.02	Krona neutral
NOK/CHF	10.15	11.01	9.84 – 12.19	Krona neutral
EUR/USD	1.04	1.13	0.99 – 1.28	Euro neutral
USD/JPY	128.42	78.99	64.15 – 93.82	Yen undervalued
USD/CNY	6.79	5.78	5.54 – 6.02	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 downward trend on the financial markets last month and acted as an inflation hedge – to some extent, at least.

Indexed performance of gold in Swiss francs
100 = 01.01.2022

Last month's sell-off affected almost all asset classes. Last month's sell-off affected almost all asset classes, including gold in recent times. After briefly peaking at 2,050 US dollars per troy ounce in March, the price stubbornly remained in a range around 1,950 US dollars for some time. But the strong dollar and rising interest rates have exerted pressure recently, with the price currently standing at around 1,800 US dollars.

Source: Web Financial Group

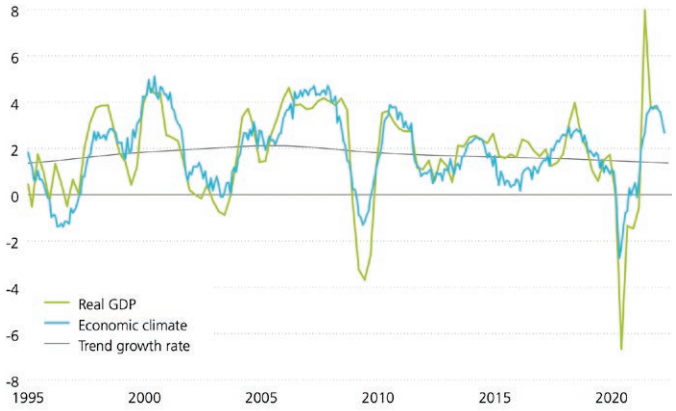
Economy

China: COVID-19 policy leads to recession

Economic indicators have worsened again worldwide over recent months. However, the economies remain on a growth trajectory, with one major exception – China, which is in the middle of a recession.

Switzerland

Growth, sentiment and trend
In percent

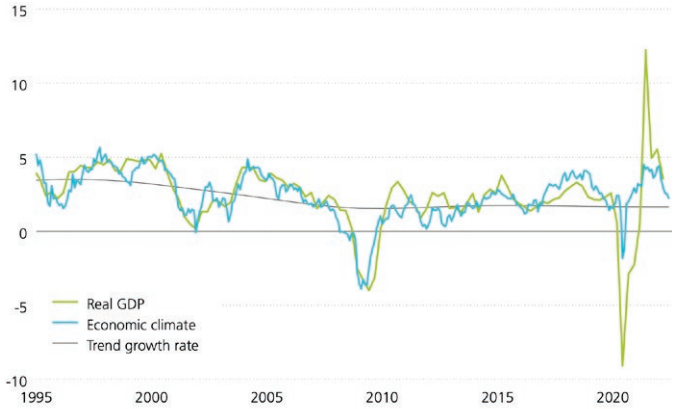


Source: Bloomberg

The leading indicators also point to slower growth in Switzerland. By international comparison, however, Swiss companies and households remain relatively optimistic. Consumer confidence has fallen to its lowest level for a year, even hitting a 10-year low in the USA and eurozone.
In 2015, the Swiss National Bank (SNB) introduced negative interest rates to halt the appreciation of the Swiss franc. The Swiss franc – measured by purchasing power – is currently at its weakest for 30 years, which means that the reason for introducing negative interest rates is no longer valid. For this reason, the SNB may raise interest rates on 16 June for the first time in 15 years.

USA

Growth, sentiment and trend
In percent

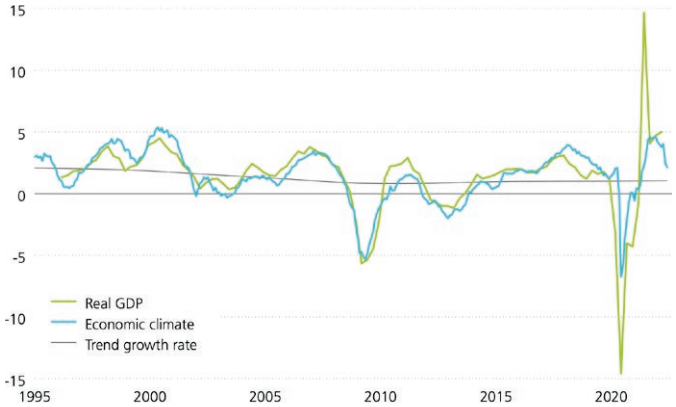


Source: Bloomberg

Demand for products and services remains strong in the USA. As the domestic economy was unable to meet US consumer demand, imports rose sharply during the first quarter, taking the trade deficit to its highest ever level. If the sentiment surveys on consumer mood prove correct, domestic demand looks set to wane soon. In light of high inflation, households have not been as pessimistic since the 2008/2009 financial crisis.
On top of the downturn in demand, the US Federal Reserve's monetary policy is increasingly having a restraining effect. The Fed has already raised interest rates twice since the start of the year, with more hikes on the way. It's also set to start offloading the government bonds purchased during the coronavirus pandemic. The planned rate of the sell-off would reduce the size of the Federal Reserve's balance sheet to the same as before the pandemic by the end of 2024.

Eurozone

Growth, sentiment and trend
In percent

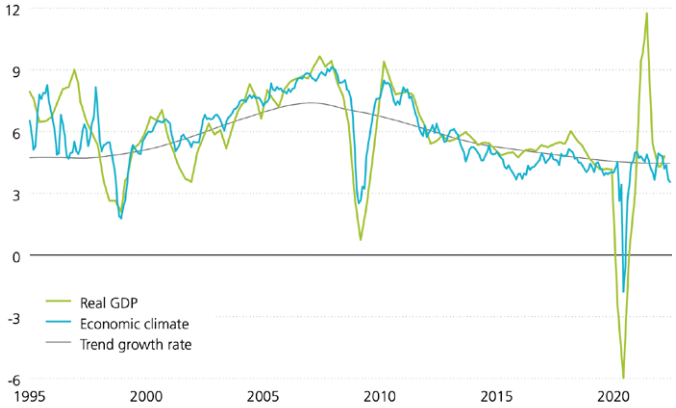


Source: Bloomberg

Until the outbreak of the Ukraine war, the sentiment indicators for the eurozone were at a record high, but they have since fallen sharply. This highlights how the war is having a greater impact on Europe than other world regions due to its geographical proximity. The downturn risks remain high: if Russia turns off the gas supplies to other European countries besides Poland and Romania, the EU may face a recession.
This increasingly leaves the European Central Bank (ECB) facing an irresolvable dilemma. While the modest growth prospects would require a supportive monetary policy, reining in high inflation calls for a more restrictive approach. The ECB is likely to make a first interest rate hike in July – which is earlier than previously announced. Inflation recently hit 7.5 percent, the highest level since the EU was founded in 1992.

Emerging markets

Growth, sentiment and trend
In percent



Source: Bloomberg

The strict coronavirus policy imposed by President Xi Jinping means that the Chinese economy is now facing a recession. Industrial production fell by 2.9 percent year-on-year, while retail sales slumped by as much as 11.2 percent. Extensive economic stimulation measures were announced, but these have had little impact so far. In contrast, inflation is the predominant issue in almost all other emerging markets. Whereas Indonesia banned the export of palm oil, wheat can no longer be exported from India – over fears that the local population would otherwise no longer be able to afford the products. This triggered fresh food price rises and further exacerbated the situation in countries dependent on food imports.

Global economic data

Indicator	Switzerland	USA	Eurozone	UK	Japan	India	Brazil	China
GDP Y/Y [1] 2021Q4	3.7%	5.5%	4.7%	6.6%	0.7%	5.4%	1.6%	4.0%
GDP Y/Y [1] 2022Q1	–	3.4%	5.0%	8.7%	–	–	–	4.8%
Economic climate [2]	↘	↘	↘	↘	↗	→	↘	↘
Trend growth [3]	1.4%	1.6%	0.8%	1.7%	1.1%	5.1%	1.2%	4.1%
Inflation	2.5%	8.3%	7.5%	7.0%	1.2%	7.8%	12.1%	2.1%
Key rates	–0.75%	1.00%	0.00%	1.00%	–0.10%	4.40%	12.75%	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.

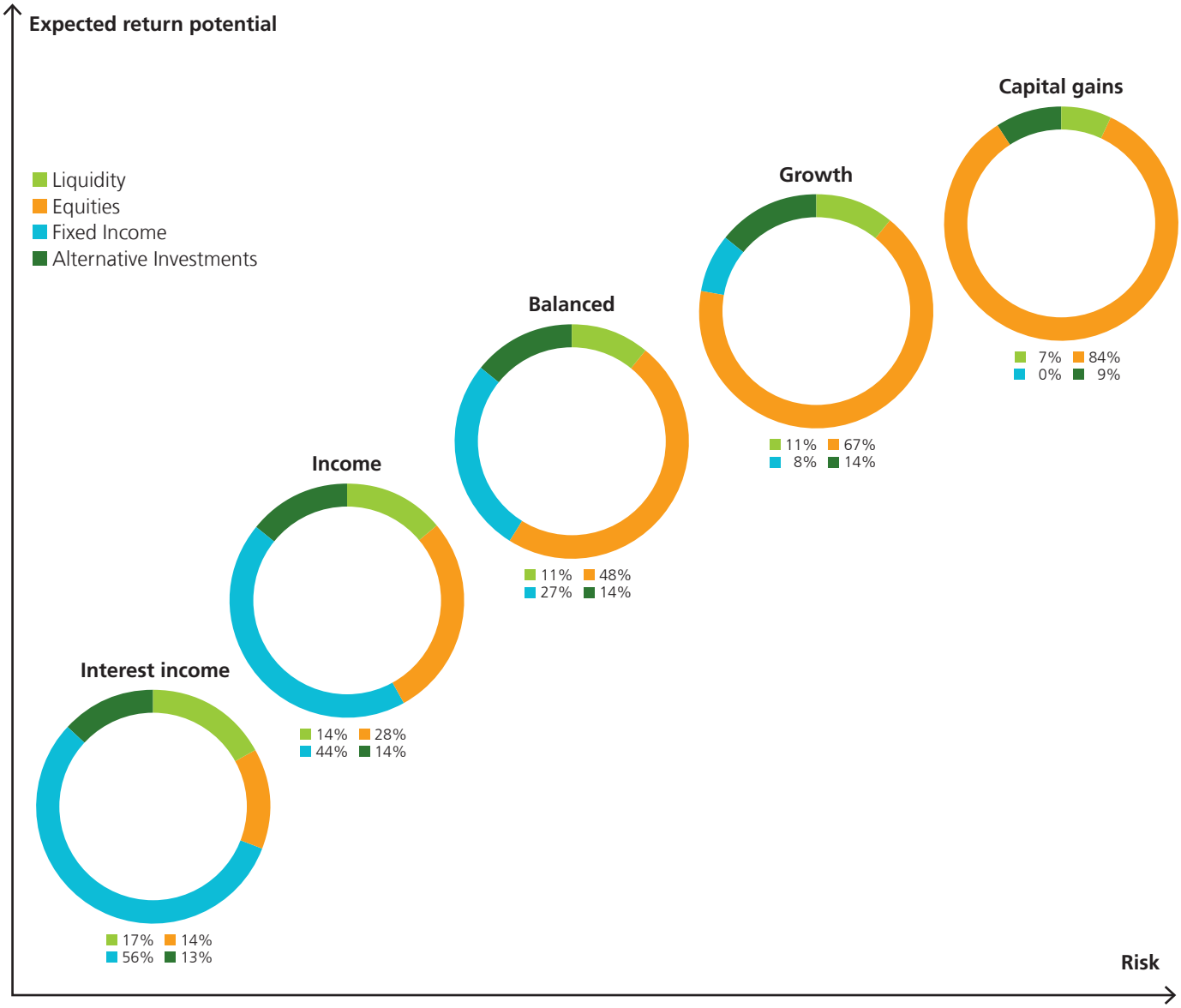
Source: Bloomberg

Model portfolios Swiss focus

Pending further measures by the central banks

Although inflation rates in the USA and Europe have probably peaked, inflationary pressure remains high and is putting central banks under pressure. More and more central banks are now deciding to raise interest rates – first and foremost the US central bank Federal Reserve (Fed), which is deliberately accepting a cooling of the economy with its aggressive fight against inflation. According to statements by representatives of the European Central Bank (ECB), the first interest rate step in the Eurozone could be due in July.

Although inflation rates in Switzerland are still significantly lower than in other European countries, the pressure on the central bank has increased. The Swiss National Bank (SNB) will therefore already have to consider a first interest rate step for its assessment of the situation on 16 June. For the SNB's credibility, an interest rate step would be appropriate, especially since the current weakness of the Swiss franc means that the justification for negative interest rates is now lacking. We therefore recommend further reducing the bond quota by underweighting Swiss bonds. We continue to adhere to the other, defensive portfolio orientation.



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