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PostFinance

Editorial

Ailing Europe

Europe cuts a miserable picture at the moment, both economically and politically. When it comes to investments in Europe, caution is advised.

Philipp Merkt
Chief Investment Officer

Europe faces a metaphorical dark and cold winter, despite the fact that gas storage tanks have now been filled: rarely before have fears over the future of the Old Continent been as pertinent as today. If the leading economic indicators are to be believed, Europe is set for a real economic slump. Equally rarely have private households been as pessimistic about their future finances as they are today.

"Europe's problems will also have an adverse impact on the Swiss economy."

While European policy is remarkably unified over foreign policy challenges, the governments of Europe appear rudderless when it comes to economic issues and are acting in a completely uncoordinated manner. Europeans seem to have lost their market economy compass. As a political response to the misguided energy policy over recent years, we're seeing gas and electricity caps and large-scale financial redistribution everywhere.

Above all, we need to be concerned for our northern neighbours. The German government is in the process of abandoning the social market economy that has made Germany so strong over the past 70 years. The state share of the German economy already stood at a huge 52 percent last year. By comparison, the state accounts for only 35 percent of total spending in Switzerland.

This year, Germany decided on additional government spending on credit to the tune of almost 400 billion euros. That's 15 percent of German GDP, or over half of Swiss GDP. Finally, there's the European Central Bank (ECB), which initially didn't want to acknowledge rising inflation in Europe. With inflation rates of over 10 percent, the ECB will be forced into further interest rate hikes. That's bad news for both the economy and financial markets.

This year, European stock exchanges have suffered moderate losses compared with their US counterparts. This was partly due to the lower weighting of tech stocks and the profits generated by the oil companies, and partly due to the ECB's initially restrained interest rate rises. This period may now be over, however, as inflation is still rising in Europe, which is making European investments increasingly unattractive. We're taking advantage of the minor temporary rally of European equities over recent weeks to sell off European equities and to buy more attractive US ones instead.

A recession in Europe will have an impact on us, too. We're part of Europe from an economic perspective, whether we like it or not. However, inflation has risen less sharply here than in our neighbouring countries. This indicates that the Swiss National Bank will raise interest rates again, although the hikes look set to be less sharp and the downturn less severe than in Europe.

Positioning

The markets are celebrating the fall in inflation in the USA

We took advantage of the rapid recovery on equity markets last month to sell off European equities. Instead, we're bulking up our US equity allocation, while remaining restrained towards equity investments overall.

The financial markets have been fluctuating between hope and resignation for months, primarily driven by the inflation trend. This largely determines how much more the central banks – particularly the US Federal Reserve – will raise key rates. It is hoped that interest rates will peak soon, after the sharp hikes in recent months. But it is also hoped that the economic damage caused by this restrictive monetary policy will not be too great.

"Stubbornly high inflation means central banks cannot yet afford to consider reducing interest rates."

Investors' hopes are currently being fed by recently published economic data. The economic growth figures for the third quarter showed an acceleration of growth in the US and sustained, albeit weaker, growth in the eurozone. However, above all else, the announcement of the fall in inflation in the USA for October was cause for celebration. While the decline in the overall inflation rate was expected, the drop in the core rate came as a surprise. This excludes sharply fluctuating energy and food prices and is a better indicator of the underlying inflation trend. While the equity markets have enjoyed one of their best months ever, the bond markets were also boosted by the surprise news on US inflation. The US dollar fell victim to this development, suffering its greatest setback since the start of the year.

Performance of asset classes

Asset class		1M in CHF	YTD [1] in CHF	1M in LCY [2]	YTD [1] in LCY [2]
Currencies	EUR	1.4%	–5.2%	1.4%	–5.2%
	USD	–3.6%	5.6%	–3.6%	5.6%
	JPY	–0.4%	–13.7%	–0.4%	–13.7%
Fixed Income	Switzerland	3.8%	–9.9%	3.8%	–9.9%
	World	–0.6%	–13.6%	3.1%	–18.2%
	Emerging markets	–0.5%	–17.4%	3.2%	–21.8%
Equities	Switzerland	8.4%	–13.4%	8.4%	–13.4%
	World	6.2%	–12.6%	10.2%	–17.2%
	USA	5.5%	–12.8%	9.4%	–17.4%
	Eurozone	14.6%	–16.0%	13.1%	–11.4%
	United Kingdom	8.2%	–3.3%	6.0%	5.7%
	Japan	1.7%	–15.2%	2.0%	–1.7%
	Emerging markets	–3.0%	–21.8%	0.6%	–26.0%
Alternative Investments	Swiss real estate	5.4%	–16.3%	5.4%	–16.3%
	Gold	0.3%	2.0%	4.1%	–3.4%

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

Data as of 10.11.2022
Source: Web Financial Group, MSCI, SIX, Bloomberg Barclays, J.P.Morgan

Underweighted equity position maintained

We do not regard last month's rapid price gains on the equity markets as sustainable. Past experience has shown that monetary policy has a delayed impact. The economic impact of the sharp hike in key rates over recent months will only truly be felt during the coming months. While we hope that the economic consequences of this policy will be brief and mild, we don't share the optimism found on the equity markets. That's why we're adopting a cautious approach to equity market positioning in the portfolios entrusted to us.

Acquisition of US equities at the expense of those from Europe

Sharp equity market fluctuations over recent weeks have made a change in regional equity positioning necessary. We are selling European equities, but increasing the allocation of those from the US. This means that we're cashing in on the strong gains made by European equities last month. With a two-digit inflation rate, European monetary policy has a long, restrictive path ahead. As a result, economic and monetary policy headwind may grow stronger and last longer in Europe.

Reducing gold investments

Finally, we've also decided to reduce the gold position in the portfolios. This has served us well this year – gold is one of the few asset classes to generate a positive return in francs since the start of the year. But in light of the increased yields on bonds and money market investments, gold is losing its appeal. We're taking advantage of recent price gains and realigning positioning to a neutral allocation.

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%					
Fixed Income	**Total**	**29.0%**	**29.0%**					
	Switzerland	17.0%	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%	8.0%					
	Eurozone	3.0%	1.0%					
	United Kingdom	2.0%	2.0%					
	Japan	2.0%	2.0%					
	Emerging markets	8.0%	8.0%					
Alternative Investments	**Total**	**18.0%**	**16.0%**					
	Swiss real estate	11.0%	11.0%					
	Gold[2]	7.0%	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
Fixed income

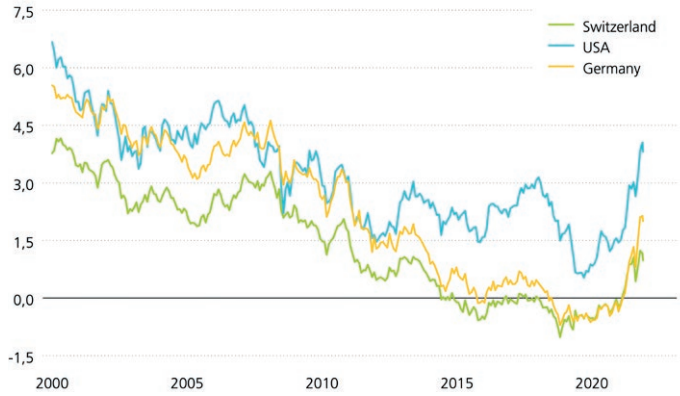
The bond markets were once again hovering around their low point for the year last month. There was great uncertainty as to whether the measures taken by the major central banks to combat inflation would have sufficient impact.

Indexed performance of government bonds in Swiss francs
100 = 01.01.2022

In 2022, the bond markets have so far faced major challenges and suffered painful losses. There is great concern over the persistent strong inflationary trend and the effectiveness of the measures taken by the major central banks to rein inflation in. However, the rigorous implementation of restrictive monetary policy and the looming economic slowdown briefly gave the bond markets some cause for optimism at the turn of the month, especially as there are growing signs that inflation rates have peaked. 10-year Swiss bonds even gained by 2 percent last month.

Source: SIX, Bloomberg Barclays

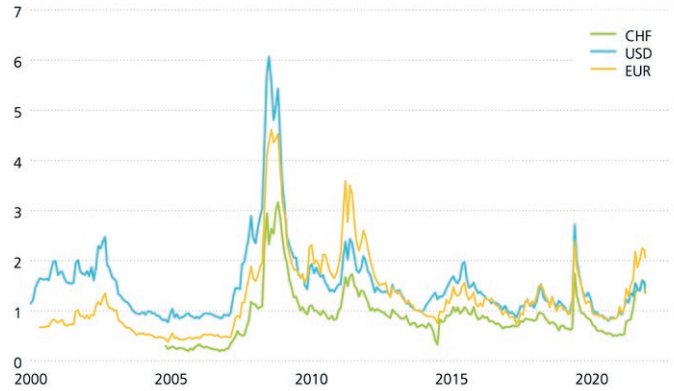
Trend in 10-year yields to maturity
In percent



The 10-year capital market interest rates in Europe and the USA once again approached their highs for the year last month. The yields to maturity on 10-year US bonds briefly climbed to 4.4 percent. Their German counterparts reached 2.2 percent. Swiss bonds bucked this trend, as did those in the UK. The latter fell by almost 1 percentage point after the new government's U-turn on fiscal policy.

Source: SIX, Bloomberg Barclays

Credit spreads on corporate bonds
In percentage points



The uncertain outlook for further economic development is also reflected on the corporate bond market. Investors still view the market environment in Europe as challenging, which is why the risk premiums being demanded on European corporate bonds remain high. The US Federal Reserve's continued restrictive monetary policy and a more secure energy supply situation in the USA have resulted in a sharp tumble for the risk premiums on corporate bonds issued in US dollars, following their peak in spring.

Source: Bloomberg Barclays

Market overview
Equities

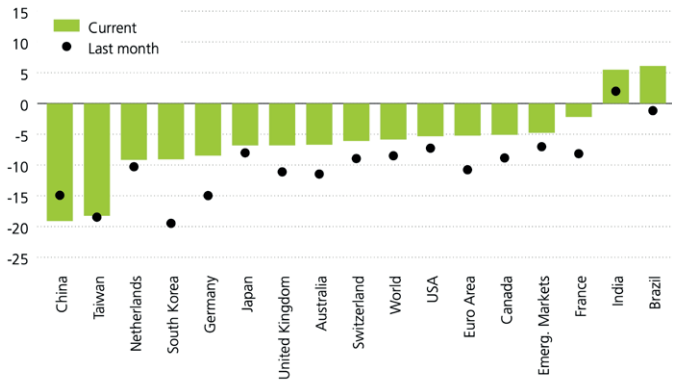
The equity markets were hit by severe losses in early autumn. The tide turned last month, and the European stock markets began to make up lost ground.

Indexed stock market performance in Swiss francs
100 = 01.01.2022

After a disastrous start to autumn, October saw the equity markets almost completely recoup the losses they had suffered during the previous month. European equities made particularly strong gains. Measured in Swiss francs, they rose by almost 14 percent. The 30 traditional companies in the US Dow Jones index made similarly impressive gains, while tech securities fell. There was also strong demand for Swiss equities, with prices increasing by 5 percent.

Source: SIX, MSCI

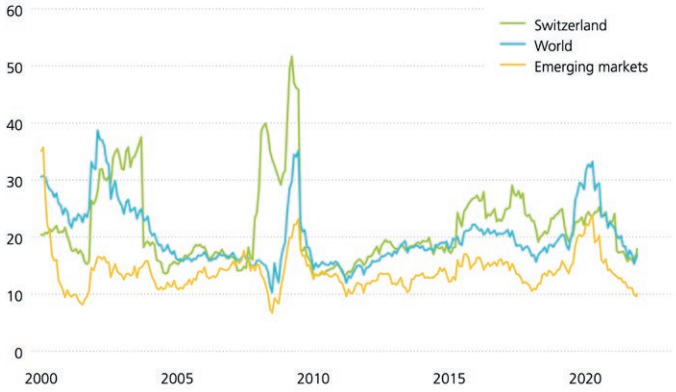
Momentum of individual markets
In percent



Momentum remained negative in most regions, despite the ground recovered on the equity markets last month. The Chinese equity market is trailing behind. Chinese equities – measured by the MSCI China – recorded losses of 15 percent last month alone. This may be explained by the National Congress of the Communist Party and the reaffirmation of coronavirus restrictions by the government. The Brazilian equity market was an outlier, making gains and benefiting from the outcome of the presidential election.

Source: MSCI

Price/earnings ratio
P/E ratio



After the coronavirus-related slump in spring 2020, corporate profits soared. But this trend appears to have flattened out recently – with company profits increasingly stagnating. For the current fourth quarter, analysts even expect the first decline in the profits of the 500 biggest US companies. However, profits are expected to start climbing again in the first quarter of 2023.

Source: SIX, MSCI

Market overview

Swiss real estate investments

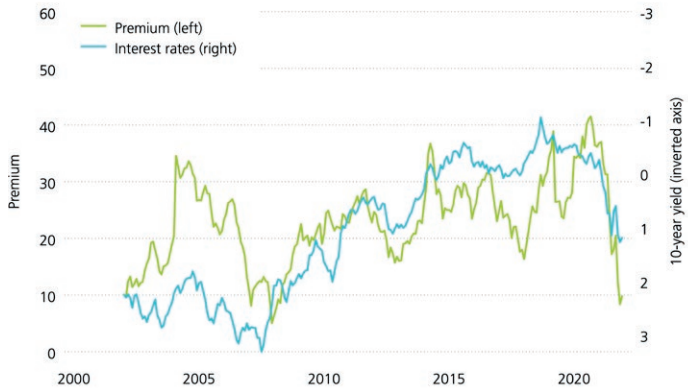
Higher interest rates are increasingly impacting on the real estate markets. The effects are now also being felt in the construction industry.

Indexed performance of Swiss real estate funds
100 = 01.01.2022

Higher interest rates are taking their toll on global real estate markets this year, resulting in losses on real estate investments. Listed real estate investments held their ground last month, and some even saw a slight upturn. There was very strong demand for Swiss real estate funds, which gained by almost 5 percent. The situation in China is challenging: due to downward momentum in the construction industry, there has already been a fall in demand for building materials and so too a decrease in prices – particularly for iron ore and steel.

Source: SIX

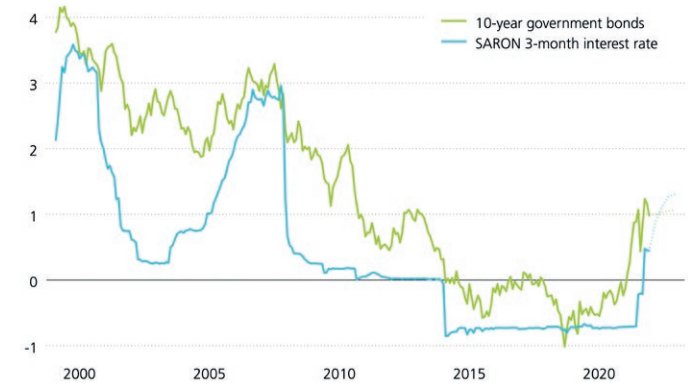
Premium on Swiss real estate funds and 10-year yields to maturity
In percent



Premiums on Swiss real estate funds remain at a record low level. On average, premiums in the upper single-figure range are being demanded on the inventory values of properties. By comparison, the average premiums were still standing at a figure of over 40 just a few months ago.

Source: SIX

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



The futures markets give an indication of market expectations for future interest rates. Short-term interest rates – measured by the three-month SARON in Switzerland – are expected to go up by 0.75 percentage points over the next 12 months. If this turns out to be the case, it will make Saron mortgages 0.75 percentage points more expensive in future. However, long-term fixed-rate mortgages – which move in line with the development of long-term capital market interest rates – have seen the sharpest rise in interest rates this year.

Source: SIX

Market overview

Currencies

The US dollar weakened again recently, as inflation rates in the USA were lower than expected. The Swiss franc and Japanese yen are weakening. The winners last month include Latin American currencies.

The US dollar was no longer able to defend its leading position last month and fell by over 6 percent – measured in terms of performance against a basket of currencies. This was despite the US Federal Reserve sticking to its word by hiking key rates again. However, the inflation trend provided a pleasant surprise in October by heading downwards. The Swiss franc and Japanese yen also weakened last month. The latter was hit by the Japanese central bank's recent confirmation of its expansive policy. In contrast, the Latin American currencies enjoyed an upturn – especially the Mexican peso, the Brazilian real and the Peruvian sol.

Currency pair	Price	PPP [1]	Neutral area [2]	Valuation
EUR/CHF	0.98	0.78	0.72–0.83	Euro overvalued
USD/CHF	0.96	0.77	0.67–0.86	USD overvalued
GBP/CHF	1.13	1.23	1.06–1.40	Pound neutral
JPY/CHF	0.68	0.96	0.80–1.11	Yen undervalued
SEK/CHF	9.10	9.28	8.39–10.16	Krona neutral
NOK/CHF	9.55	10.68	9.54–11.82	Krona neutral
EUR/USD	1.02	1.01	0.88–1.14	Euro neutral
USD/JPY	141.72	80.02	64.07–95.97	Yen undervalued
USD/CNY	7.19	5.62	5.30–5.93	Renmimbi undervalued

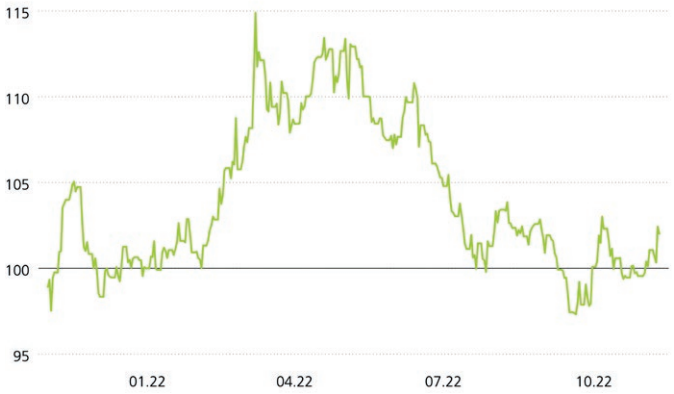
[1] Purchasing power parity. This metric calculates an exchange rate using relative inflation rates.
[2] Range of historically normal fluctuations.

Source: Web Financial Group

Gold

The gold price has been volatile recently, with a fluctuation margin of over 100 US dollars.

Indexed performance of gold in Swiss francs
100 = 01.01.2022



The troy ounce price has fluctuated significantly over recent weeks. It dipped close to the mark of 1,600 US dollars several times, only to soar again shortly afterwards. Gold, measured in US dollars, remains well down on the start of the year – almost 6 percent. From the perspective of Swiss investors, the precious metal has proven a useful way of stabilizing portfolios and has even achieved a slight price gain.

Source: Web Financial Group

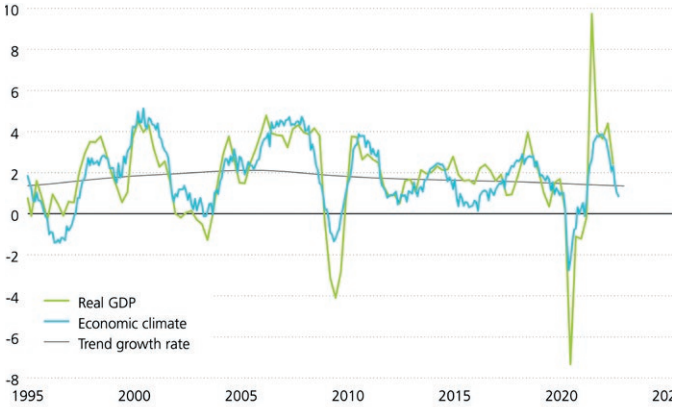
Economy

Winter recession ahead

The USA is expected to go into recession over the winter, and Europe will shortly enter one, too.

Switzerland

Growth, sentiment and trend
In percent

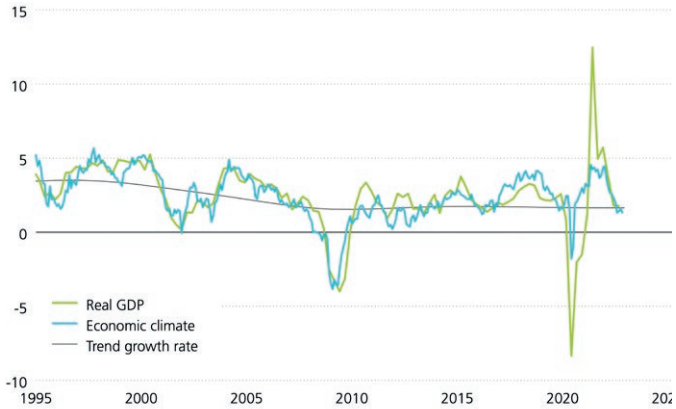


Source: Bloomberg

The global deterioration in business sentiment was also evident amongst Swiss companies last month. While production figures remain high for the moment, order volumes are beginning to drop off. The fact that imports are still seeing strong growth indicates that the domestic economy is still intact. However, lower export growth, extremely pessimistic consumer sentiment and the first signs of a slowdown in the construction industry all spell bad news. Switzerland also looks set to enter recession over the winter. A brief fall in inflation figures does not detract from the fact that inflation is likely to start rising again at the start of the year. The Swiss National Bank is expected to raise interest rates again by December at the latest.

USA

Growth, sentiment and trend
In percent

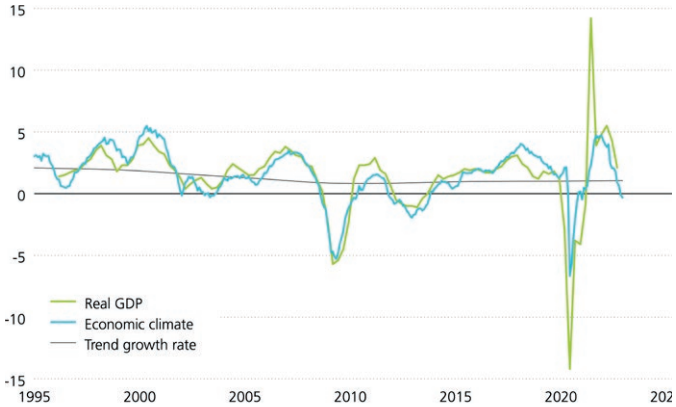


Source: Bloomberg

Just for once, US inflation provided a genuinely positive surprise. After the core rate of inflation rose again in the previous month, the significant decline in the overall and core rates in October dispelled fears for the time being that the US Federal Reserve will implement a much more restrictive monetary policy. With the core rate standing at 6.3 percent, however, the assumption of further interest rate hikes does not seem implausible. The deteriorating economic outlook in construction and the persistence of historically low consumer sentiment mean a recession in the US economy seems inevitable. More and more companies appear to be gearing up for such a scenario, as the future no longer looks quite so rosy.

Eurozone

Growth, sentiment and trend
In percent

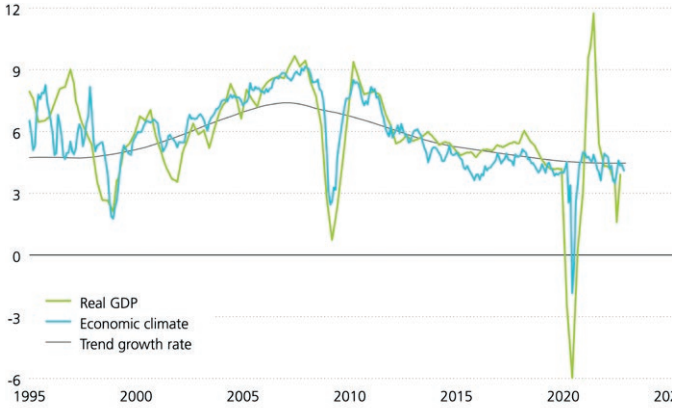


Source: Bloomberg

After strong growth in Europe in the first half of the year, the first signs of sluggishness emerged during the third quarter. The European economy expanded by 1.6 percent over the first nine months of the year. By comparison, the USA achieved a rise of just 0.1 percent in GDP over the same period. In sharp contrast, the economic signs here now suggest a storm is coming. Weak sentiment across the board has been combined with the devastating effects of inflation, which has now reached 10.7 percent. With money market rates standing at between 1.5 and 2 percent, it now looks like the European Central Bank (ECB) still has a long way to go in terms of adjusting interest rates to the new inflationary environment.

Emerging markets

Growth, sentiment and trend
In percent



Source: Bloomberg

The economic development in the emerging markets remains patchy. While China is still contending with flagging economic performance, other countries have emerged as growth engines. This applies to India, for example, where real GDP grew at an annual rate of 5.4 percent in the third quarter. Indonesia achieved impressive growth of 5.7 percent. Even stronger was the performance in Vietnam, where real growth stood at over 13 percent – although this can be explained by a pandemic-related slump of 6 percent last year. Apart from China, the economy seems remarkably robust, even though the strong US dollar could increasingly hold back growth.

Global economic data

Indicator	Switzerland	USA	Eurozone	UK	Japan	India	Brazil	China
GDP Y/Y [1] 2022Q2	2.4%	1.8%	4.3%	4.4%	1.6%	13.5%	3.2%	0.4%
GDP Y/Y [1] 2022Q3	–	1.8%	2.1%	2.4%	–	–	–	3.9%
Economic climate [2]	↘	↘	↘	↘	↘	↘	↘	↘
Trend growth [3]	1.3%	1.6%	0.8%	1.7%	1.1%	5.1%	1.3%	4.0%
Inflation	3.0%	7.7%	10.7%	10.1%	3.0%	6.7%	6.5%	2.1%
Key rates	0.50%	4.0%	2.0%	3.0%	–0.10%	5.9%	13.75%	4.35%

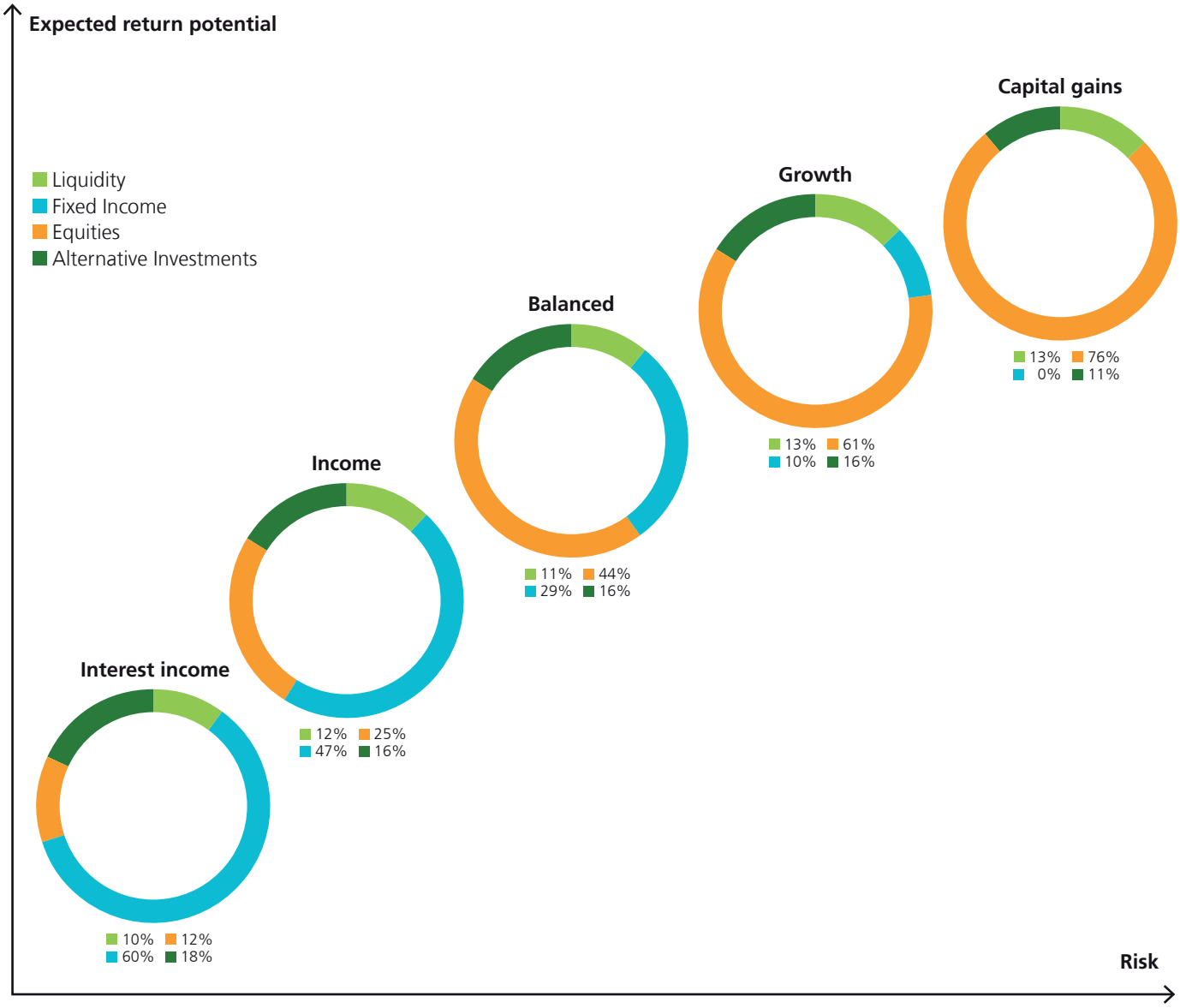
[1] Growth compared to year-ago quarter
[2] Indicator, measuring the overall sentiment and typically leading 1 to 2 quarters in advance of GDP. Green arrow indicates an increasing economic growth, red arrow a slowing.
[3] Potential growth. Long-term change in gross domestic product with sustainable capacity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

Source: Bloomberg

Model portfolios Swiss focus

Castling in regional stock market positioning

The stock markets have had one of the best starts to a quarter. Especially on the European stock markets, prices have risen rapidly since the beginning of October. However, the stubbornly high inflation - now in double digits - will continue to challenge European monetary policy, and thus also the economy, for a long time. We are reducing our exposure to European equities, taking the gains of the last few weeks with us. In return, we are buying American equities and reducing the underweight in the USA. Overall, we are maintaining a below-average equity positioning.
Gold investments have served the portfolios well since the beginning of the year. However, with the rise in interest rates, this asset class is becoming less interesting. We are reducing the position to the neutral strategy weight.



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