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# SoundInsight N°5

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Headline inflation falls below core inflation

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## Economy at a crossroads

The highest interest rate level since 2008 is taking its toll on the financial sector. Further effects of the current central bank tightening cycle are likely to be felt over the coming months.

Higher interest rates generally result in decreasing money supply, more expensive financing, declining investments, reduced consumption, and thus an economic contraction. This is the roadmap of central banks, which still aim to curb inflation. Although the negative economic effects of tightening interest rates are well-known to economists, opinions are currently divided on how much the interest rate hikes of the past 12 months will impact the global economy.

US inflation has been on a downward trajectory since June 2022, about three months after the beginning of interest rate tightening. In March, inflation measured over a year eased to 5%, its lowest level since May 2021. However, the main driver during that period was the oil price, which fell by almost 40%. If we exclude food and energy prices from the measurement, there is a persistent core inflation that has remained almost unchanged at over 5.5% since 2022. Interestingly, last month, headline inflation in the US fell below core inflation. Looking at Europe, this development is even more striking, as core inflation has been steadily rising since 2021, in contrast to shrinking headline inflation. It is thus clear that the task of central banks in terms of fighting inflation is not yet fully completed. Nevertheless, numerous leading indicators point to a downturn in the economy, which suggests that the last interest rate hike from the Federal Reserve in the current cycle is likely to take place in May.

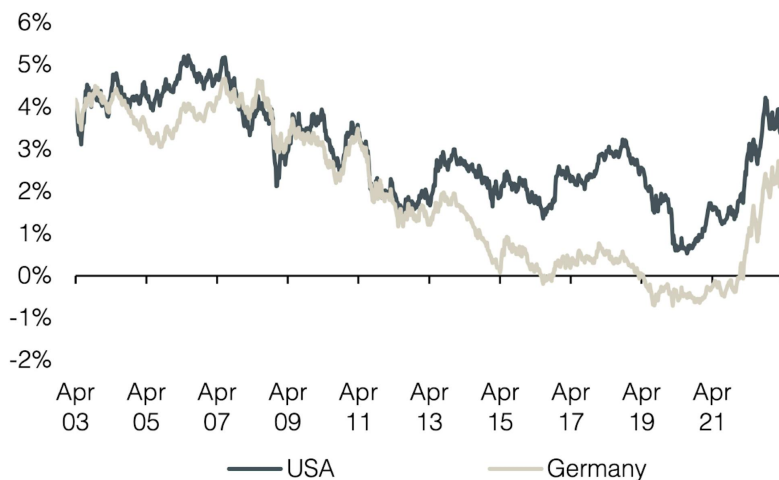
The US economy has shown resilience, particularly in terms of the labor market, which left central bankers with no choice but to continue the steepest tightening path in modern history. However, current events in the financial sector show that the economy is operating in a fragile state in which the negative consequences of high interest rates can quickly spiral out of control. Since the impact of rising interest will arrive with a lag, it is not surprising that the global economy is currently at a crossroads, about a year after the start of the current tightening cycle.

In its recently published study, the International Monetary Fund (IMF) reduced the growth outlook for the global economy and estimated that in the medium term the world economy is unlikely to return to the growth rates that prevailed before the pandemic. The institution, based in Washington, D.C., stated that global growth of about 3% can be expected in five years. This corresponds to the lowest medium-term forecast in an IMF report since 1990. The publication also reaffirms that in addition to monetary tightening, new concerns about financial stability are likely to have a negative impact on growth. This is already evident when observing declining credit volumes.

As expected, US banks have already tightened lending conditions. In Europe, bank lending has decreased for three consecutive months, which typically only occurs during times of a severe economic downturn. While credit availability is currently falling, the effects of this are being felt with a time lag. Leading indicators in the manufacturing sector already suggest that the labor market is likely to cool down in the coming months. A significant increase in jobless claims would be the missing puzzle piece in successfully getting inflation under control. However, these effects are expected to be accompanied by lower corporate profits and consequently a recession. According to estimates from Bloomberg Economics, the probability of a US recession this year is 100%.

The increasing visibility regarding a successful fight against inflation confirms our preference for long-dated government bonds and investment-grade corporate bonds. We are taking advantage of the attractive interest rate environment to further extend the maturities. High-quality bonds are also expected to regain their diversifying effect in the face of an economic slowdown. However, regional differences for USD, GBP, EUR, and CHF persist. From our perspective, credit spreads are likely to rise, which is why we continue to recommend a defensive positioning regarding credit risks. Equities remain underweight. We are taking the strong outperformance of US equities as an opportunity to reduce the region and thus also the associated high allocation to technology stocks. An additional reason for underweighting US equities is to reduce concentration risks, as around 87% of the total contribution to upside performance in the first quarter came from only 10 companies.

10 Year Government Bonds



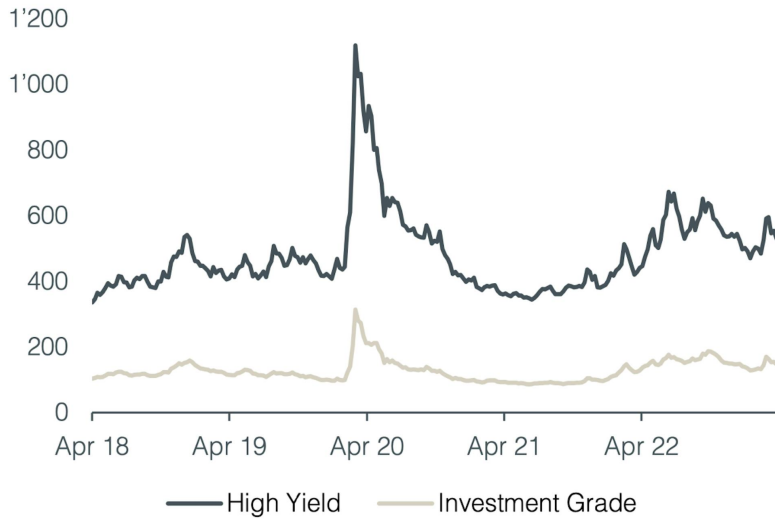
## Yields

Falling inflation expectations have caused the expected real yields for longer maturities to rise somewhat. We still see the current interest rate level as an opportunity to gradually increase maturities and, in view of a weakening economy, to lock-in yield levels for a longer period.



Source: Bloomberg

Global Credit Spreads (in bps)

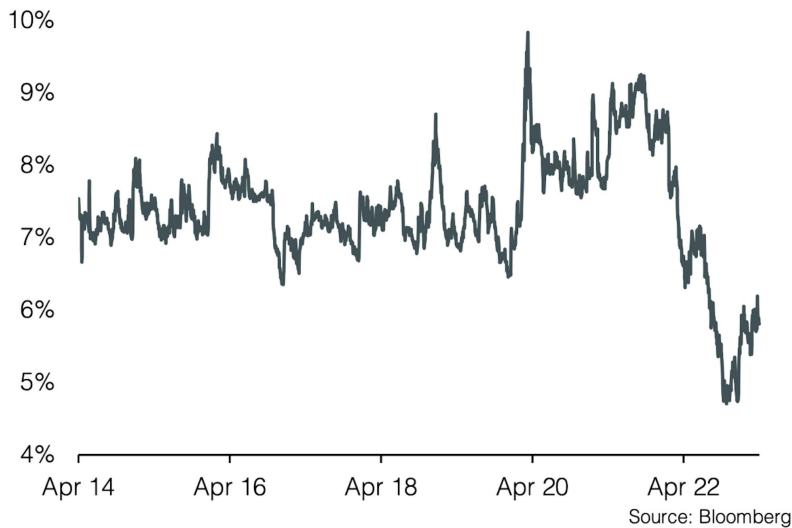


## Spreads

The increased probability of a recession is reflected when looking at credit spreads. The lower the quality, the greater the spread widening last month. However, in our view, the spreads for high yield bonds have still not reached an attractive level. We maintain our preference for high quality and believe that opportunities will arise soon in the area of riskier bonds.

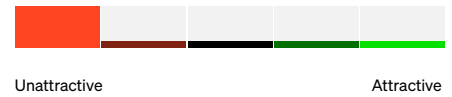


Equity Risk Premium USA



## Equity Risk Premium

Risk premiums remain at an unattractive level and have fallen slightly in line with higher equity prices over the past month. A sharp rise in risk premiums would require lower equity markets or significantly lower interest rates.



Source: Bloomberg

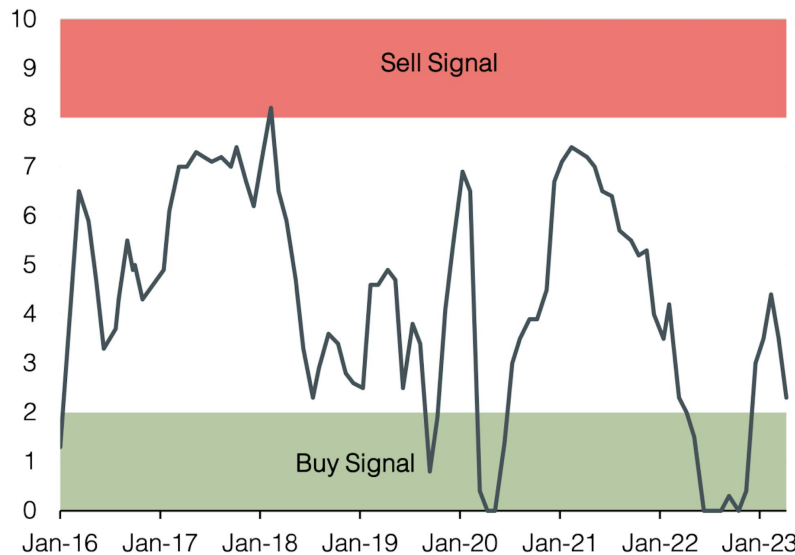
## Leading Indicators

Manufacturing PMI

	Jun 21	Jul 21	Aug 21	Sep 21	Oct 21	Nov 21	Dec 21	Jan 22	Feb 22	Mar 22	Apr 22	May 22	Jun 22	Jul 22	Aug 22	Sep 22	Oct 22	Nov 22	Dec 22	Jan 23	Feb 23
Global	55.5	55.4	54.1	54.1	54.2	54.2	54.3	53.2	53.7	52.9	52.3	52.3	52.2	51.1	50.3	49.8	49.4	48.8	48.7	49.1	50.0
USA S&P Global	62.1	63.4	61.1	60.7	58.4	58.3	57.7	55.5	57.3	58.8	59.2	57.0	52.7	52.2	51.5	52.0	50.4	47.7	46.2	46.9	47.3
USA ISM	61.1	60.0	59.6	60.7	60.4	60.8	58.6	57.6	58.4	57.0	55.9	56.1	53.1	52.7	52.9	51.0	50.0	49.0	48.4	47.4	47.7
Europe	63.4	62.8	61.4	58.6	58.3	58.4	58.0	58.7	58.2	56.5	55.5	54.6	52.1	49.8	49.6	48.4	46.4	47.1	47.8	48.8	48.5
Germany	65.1	65.9	62.6	58.4	57.8	57.4	57.4	59.8	58.4	56.9	54.6	54.8	52.0	49.3	49.1	47.8	45.1	46.2	47.1	47.3	46.3
United Kingdom	63.9	60.4	60.3	57.1	57.8	58.1	57.9	57.3	58.0	55.2	55.8	54.6	52.8	52.1	47.3	48.4	46.2	46.5	45.3	47.0	49.3
France	59.0	58.0	57.5	55.0	53.6	55.9	55.6	55.5	57.2	54.7	55.7	54.6	51.4	49.5	50.6	47.7	47.2	48.3	49.2	50.5	47.4
Italy	62.2	60.3	60.9	59.7	61.1	62.8	62.0	58.3	58.3	55.8	54.5	51.9	50.9	48.5	48.0	48.3	46.5	48.4	48.5	50.4	52.0
Spain	60.4	59.0	59.5	58.1	57.4	57.1	56.2	56.2	56.9	54.2	53.3	53.8	52.6	48.7	49.9	49.0	44.7	45.7	46.4	48.4	50.7
Sweden	65.7	65.0	60.5	64.7	64.3	63.2	61.3	62.0	57.6	56.7	54.6	54.5	53.0	52.1	49.6	49.0	46.7	46.0	46.0	47.0	47.0
Switzerland	67.1	70.0	67.3	67.4	66.3	64.1	64.5	63.7	62.7	63.3	61.6	59.8	59.1	58.0	56.7	56.8	55.4	54.4	54.5	49.3	48.9
China Local	50.9	50.4	50.1	49.6	49.2	50.1	50.3	50.1	50.2	49.5	47.4	49.6	50.2	49.0	49.4	50.1	49.2	48.0	47.0	50.1	52.6
China Caixin	51.3	50.3	49.2	50.0	50.6	49.9	50.9	49.1	50.4	48.1	46.0	48.1	51.7	50.4	49.5	48.1	49.2	49.4	49.0	49.2	51.6
Japan	52.4	53.0	52.7	51.5	53.2	54.5	54.3	55.4	52.7	54.1	53.5	53.3	52.7	52.1	51.5	50.8	50.7	49.0	48.9	48.9	47.7

Description: The Purchasing Managers' Index (PMI) is a forward-looking economic indicator based on company surveys. A value above 50 indicates an improving economic environment, whereas a value below 50 indicates a worsening environment.

The ISM Manufacturing Index in the US is approaching 45 points, a level which in the past has indicated a deterioration of the labor market and a coming recession. Interesting conclusions can also be drawn from the decomposition of the index: At 44.3, the survey score for "new orders" has reached a level that in the past was associated with lower future corporate profits. However overall, leading indicators remain neutral for the time being, despite a deterioration over the last month.

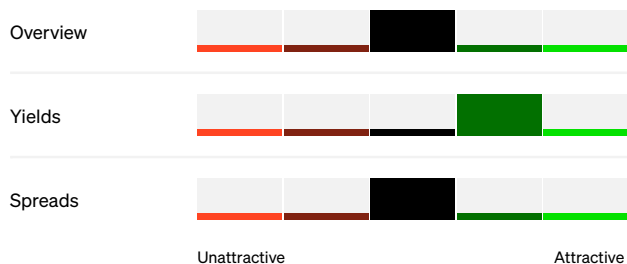


## Risk-Index

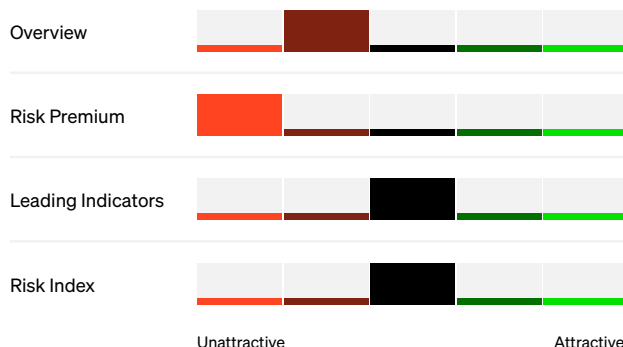
The risk index is approaching a buy signal, which is somewhat surprising given this year's positive market development. Inflows into money market funds and a defensive stance in bonds are responsible for the rather worried investor sentiment. However, to trigger a clear buy signal, significant outflows from equities and lower prices are needed. Thus, the indicator currently remains neutral.



## Bonds



## Equities



## Appendix

Sound Invest is the central tool for our investment allocation. We use it to systematically and consistently assess the aspects that are relevant to the development of the financial markets. As a result, our clients can rely on a rational and anti-cyclical implementation of our investment decisions.

- **Focusing on the essentials** Interest rate level, risk premium, valuation, economic development, investor sentiment and positioning. These are the decisive factors for success on the financial markets, especially in turbulent times when the temptation to react irrationally to the headlines is particularly strong.
- **Comparability over time and place**  
The factors mentioned above are equally relevant for all markets and at all times. This is the result of a strict «backtesting» process that continues into the future.
- **Cumulating our investment experience**  
Our strength lies in the many years of experience of our partners and principals. It is precisely this experience that we summarize and make it applicable with Sound Invest.
- **Transparency**  
Thanks to our monthly publication, our clients always know where we stand in the investment cycle and how we expect the financial markets to develop.

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