SoundCapital™

Posted 1/26/2023 by Christian Luchsinger

SoundInsight N°2

01
Major long-term interest rates retreat from highs

02
Inflation expectations fall significantly

03
Divergence between markets and central banks creates tension

04
Equities remain underweight

Central banks face a credibility issue

An increasing gap between market expectations and official predictions from central banks shows declining trust in monetary policymakers.

The Federal Reserve's official communication at the December 2022 meeting was clear: interest rates will continue to rise in 2023. The so-called "dot plot," which graphically represents the committee's rate projection, forecasts a key interest rate of 5.125% at the end of this year. Not a single voting member expects unchanged or even lower interest rates during the year. If the committee has its way, another 3-4 interest rate hikes of 0.25% each will follow over the next 8 meetings.

However, the expectations of market participants, as seen in the derivatives market, differ significantly from the forecasts of the Federal Reserve. At the end of the year, interest rates are expected to remain unchanged at 4.25%, compared to the current level. While higher interest rates are expected in the middle of the year, rate cuts of the same magnitude are already priced in thereafter. This creates tension. Thus, the market disagrees with the Federal Reserve and does not believe in the official projections.

This is not surprising, as in early 2022, monetary policymakers had guided for rates of 0.75% for the end of 2022, which was priced into the market at the time. As we know now, interest rates rose by a much higher magnitude to 4.25%.

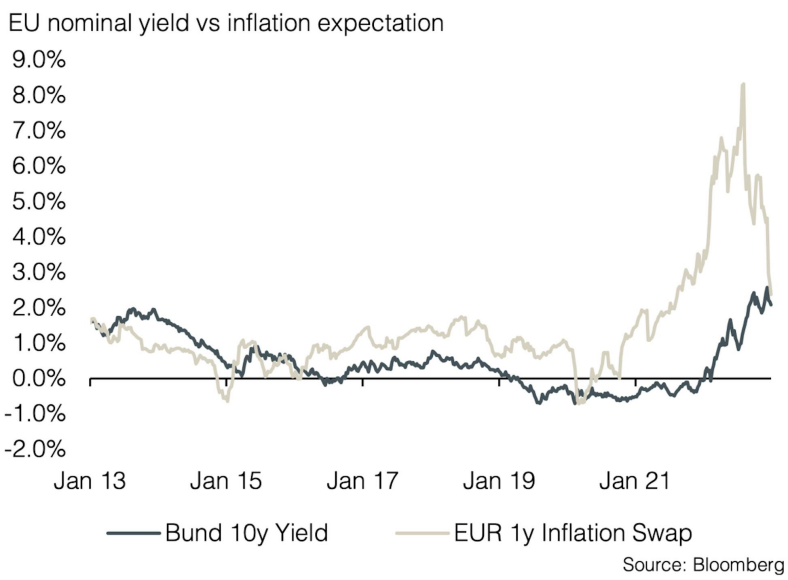
The issue of diverging interest rate expectations between the market and monetary authorities is not new and has been addressed in previous Sound Invest publications. Central banks as prisoners of financial markets were last seen in late summer 2019. Back then, an inverted US yield curve was decisive in the pressure on central banks. Fearing a recession and severe market dislocations, the central bank complied with the market's pressure and lowered key interest rates to provide relief. However, the pandemic followed shortly thereafter, which pushed this remarkable situation somewhat into an insignificant past.

However, the current situation is only partially comparable to 2019, as there were no signs of inflation back then. Nevertheless, there are parallels. The market sees the growing danger of a recession and, despite the inflationary environment, expects monetary authorities to try and rescue the economy once again. Thus, in 2023, either the central banks or the market participants will be wrong. Which expectations come true will probably depend on the further development of inflation.

Moreover, there are divergences in expectations regarding inflation. The Fed sees an inflation rate of 3.1% over the coming year, while the market assumes 2.0%. Even if inflation turns out to be declining and less problematic, it will determine the market's course for the rest of the year. A reason to be cautious: If market participants are right, inflation is under control. However, lower interest rates are already priced into the market. A euphoric reaction to a Fed rate change is therefore unlikely. The situation is different if the Committee's expectation comes true: If interest rates rise more than expected or stay at elevated levels, this could temporarily lead to high volatility or even market disruptions.

In terms of inflation, we continue to focus on wage developments. Renowned economists have highlighted several times that the key to fighting inflation is lower wages. Wages fall as unemployment rises, and rising unemployment is the result of a recession. As a consequence, the effective fight against inflation might only be achieved at the cost of a recession.

In the view of the Investment Committee, the increased risk of recession is not yet sufficiently reflected in financial markets. For example, corporate earnings are expected to grow by 4% in 2023, despite a slowdown in economic growth. We therefore maintain an unchanged tactical underweight in equities, favoring companies with stable cash flows and dividends as well as the healthcare sector. In the fixed income space, we focus on high-quality and government bonds, recommending a higher weighting in USD and GBP markets given superior real yields.



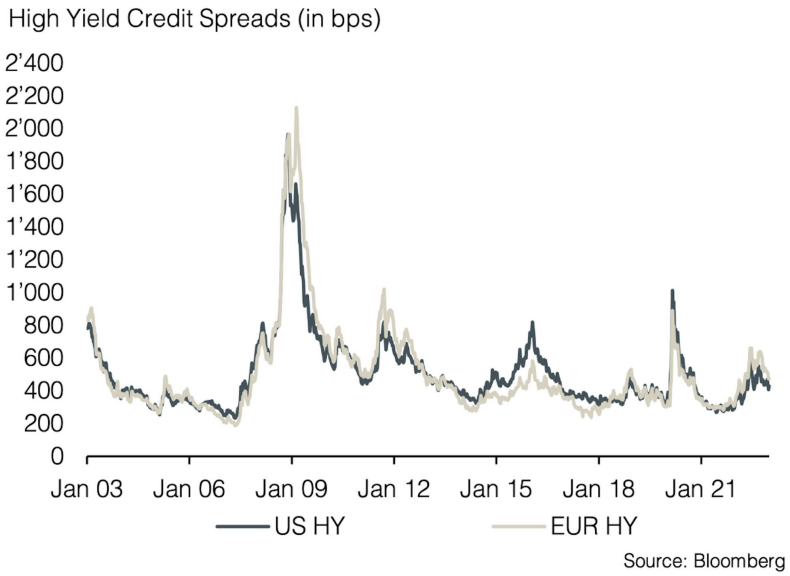
Source: Bloomberg

Yields

In recent months, there has been a noteworthy development of government bond yields and the yield curve. Both in the US and in Europe, interest rates have fallen since the start of the year. Lower inflation data from the US triggered a significant correction in short-term inflation expectations. For example, since the beginning of the year, US inflation expectations for the next 12 months have dropped from 2.5% to 2.0%, while the same figure in Europe has nearly halved from 4.5% to 2.3%. This is positive news for bonds, as inflation expectations have fallen significantly more than interest rates.



Unattractive Attractive



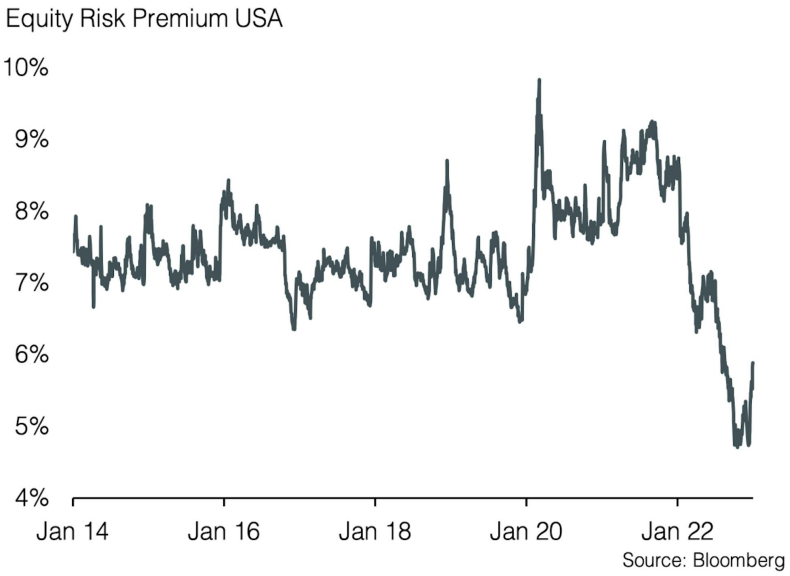
Source: Bloomberg

Spreads

Due to a strong start to the new year, a lot of capital flowed into bond markets, which also caused credit spreads to decrease. In our view, there is too much complacency, particularly in the area of high-yield bonds. At current levels, credit spreads look increasingly unattractive and mispriced given the highly inverted yield curve. The outlook for falling interest rates may be positive, but we currently prefer quality and avoid non-investment grade bonds. The indicator remains at a neutral level.



Unattractive Attractive



Source: Bloomberg

Equity Risk Premium

A slight increase in the US equity risk premium shows a clear link between the growth forecasts and higher interest rates. Due to falling interest rates, the growth outlook over the next 5 years has risen again causing the equity risk premium to rise slightly. Nevertheless, risk premiums in most countries are still at an unattractive level. Hence, the assessment remains unchanged.



Unattractive Attractive

Leading Indicators

Following an easing of COVID measures in China, a regional improvement in Europe is becoming apparent in the manufacturing PMI. Sentiment seems to be stabilizing in Germany, Italy as well as Spain, albeit still at low levels. A trend reversal is not yet clearly visible, but we will closely monitor the situation.

Manufacturing PMI

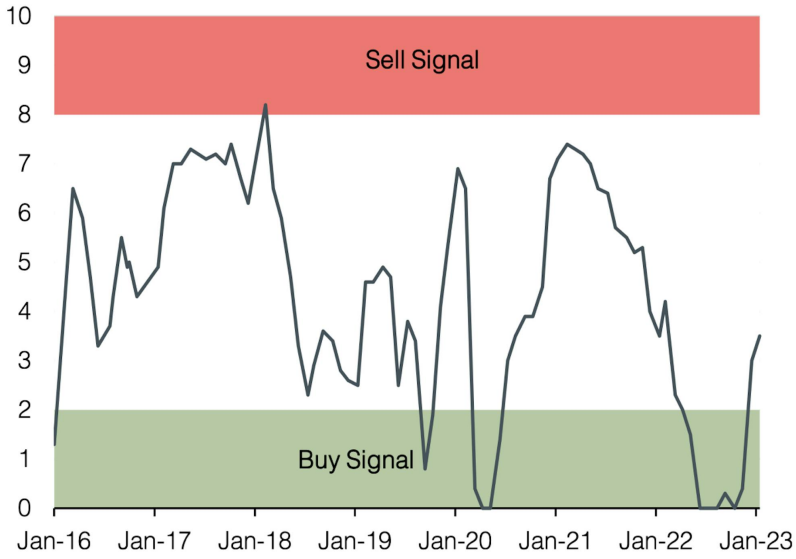
	Apr 21	May 21	Jun 21	Jul 21	Aug 21	Sep 21	Oct 21	Nov 21	Dec 21	Jan 22	Feb 22	Mar 22	Apr 22	May 22	Jun 22	Jul 22	Aug 22	Sep 22	Oct 22	Nov 22	Dec 22
Global	55.8	56.0	55.5	55.4	54.1	54.1	54.2	54.2	54.3	53.2	53.7	52.9	52.3	52.3	52.2	51.1	50.3	49.8	49.4	48.8	48.6
USA S&P Global	60.5	62.1	62.1	63.4	61.1	60.7	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
USA ISM	60.6	61.6	60.9	59.9	59.7	60.5	60.8	60.6	58.8	57.6	58.6	57.1	55.4	56.1	53.0	52.8	52.8	50.9	50.2	49.0	48.4
Europe	62.9	63.1	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
Germany	66.2	64.4	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
United Kingdom	60.9	65.6	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
France	58.9	59.4	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
Italy	60.7	62.3	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
Spain	57.7	59.4	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
Sweden	68.8	65.8	65.8	65.0	60.5	64.6	64.2	63.0	61.1	61.8	57.9	57.1	54.7	54.5	53.1	52.2	49.7	48.9	46.6	45.9	45.9
Switzerland	68.3	68.6	67.1	70.0	67.0	67.6	65.7	63.8	64.2	63.8	62.6	64.0	62.5	60.0	59.1	58.0	56.4	57.1	54.9	53.9	54.1
China Local	51.1	51.0	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
China Caixin	51.9	52.0	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
Japan	53.6	53.0	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

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.



Unattractive Attractive

Risk-Index



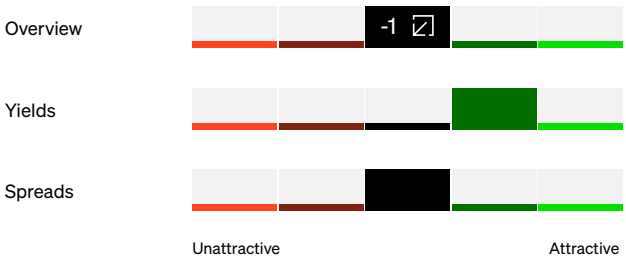
The risk index remains unchanged in neutral territory. The improved sentiment can easily be explained by rising financial markets since the beginning of the year. There are positive aspects from a statistical point of view: since 1929, January has determined the further course of markets for the year as a whole. In 71% of cases, equities ended in positive territory for the year if January ended positively.



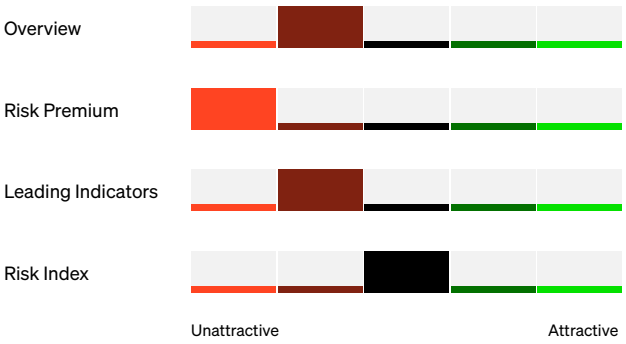
Unattractive Attractive

SoundCapital™

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.

Disclaimer

This document is an advertisement and is intended solely for information purposes and for the exclusive use by the recipient. This document was produced by Sound Capital Ltd. (hereafter «SC») with the greatest of care and to the best of its knowledge and belief. However, SC does not warrant any guarantee with regard to its correctness and completeness and does not accept any liability for losses that might occur through the use of this information. This document does not constitute an offer or a recommendation for the purchase or sale of financial instruments or services and does not discharge the recipient from his own judgment. Particularly, it is recommended that the recipient, if needed by consulting professional guidance, assess the information in consideration of his personal situation with regard to legal, regulatory and tax consequences that might be invoked. Although information and data contained in this document originate form sources that are deemed to be reliable, no guarantee is offered regarding the accuracy or completeness. A past performance of an investment does not constitute any guarantee of its performance in the future. Performance forecasts do not serve as a reliable indicator of future results. This document is expressly not intended for persons who, due to their nationality or place of residence, are not permitted access to such information under local law. It may not be reproduced either in part or in full without the written permission of SC.

© 2024 Sound Capital AG.
Datasource: Bloomberg, BofA ML Research