SoundCapital™

SoundInsight N°7

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Global equity markets continue to recover

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Central banks continue to raise interest rates

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Wage growth keeps core inflation persistent

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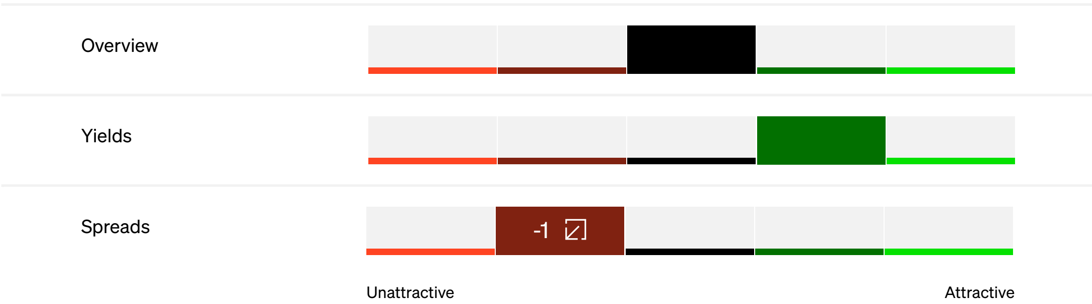
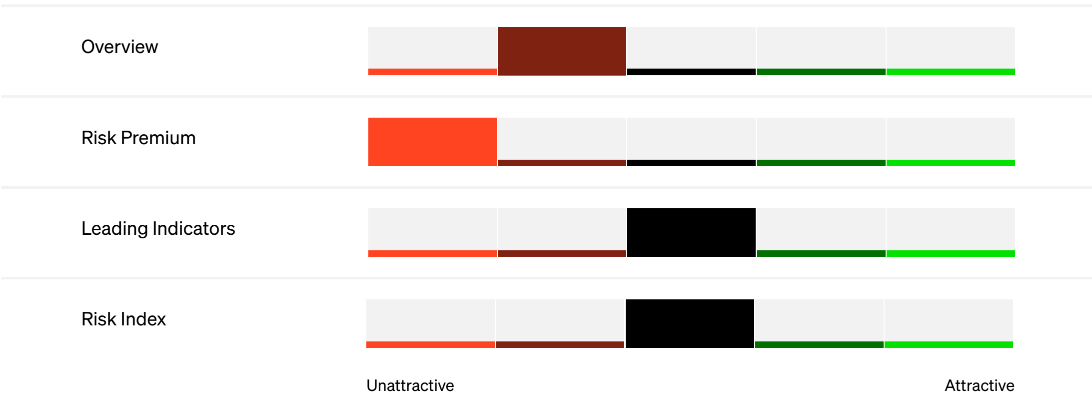
Equities remain underweight

Bonds



Equities



Posted 6/30/2023 by Christian Luchsinger

Focus on the labor market

Despite declining inflation, central banks persistently continue to raise interest rates. In doing so, they increasingly focus on the tight labor market.

Professional investors were unequivocal in their opinions at the end of last year: the significant increase in interest rates would gradually impact the economy and trigger a recession going forward. Consequently, investors adopted a defensive stance in their portfolios. However, at the beginning of this year, global stock markets exhibited a robust recovery. Even disruptions in a fragile financial system, such as the collapse of three US regional banks and the UBS takeover of Credit Suisse, resulted in temporary losses only. Particularly, major US technology companies thrived as the conviction grew that they would benefit the most from the expanding significance of artificial intelligence. This stock market resurgence presented a challenge for many defensively positioned investors, forcing them to change their allocations. The decrease in cash holdings since the start of the year indicates an improved risk sentiment among investors. Additionally, the decline in inflation likely contributed to this positive shift. In the US, the headline inflation rate has dropped from its peak of 9.1% in June 2022 to 4%.

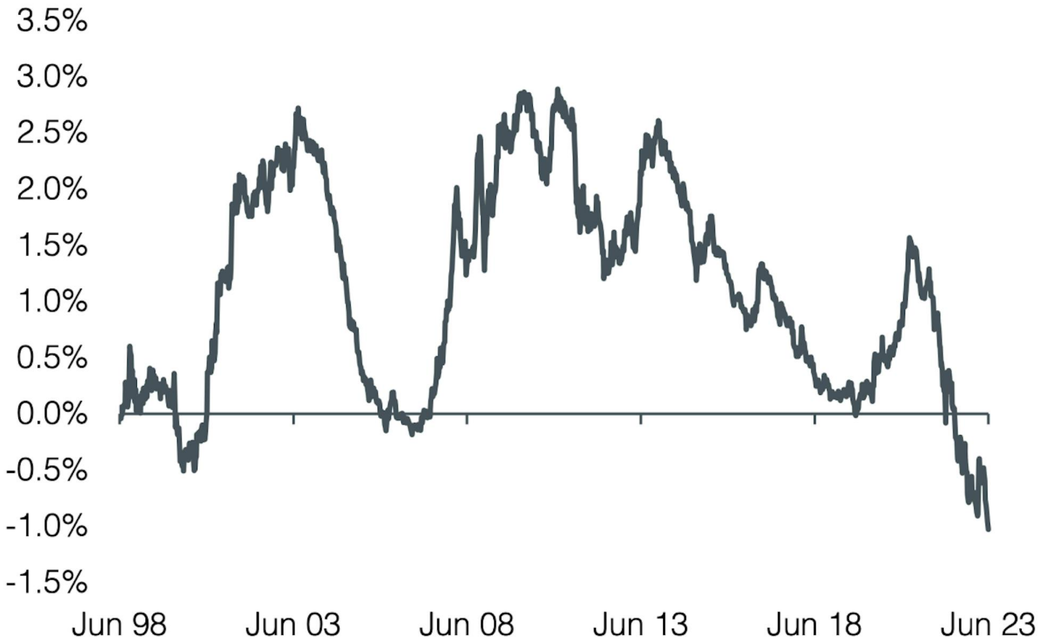
Central banks currently show limited optimism regarding the effectiveness of their efforts to combat inflation. While the Federal Reserve refrained from raising interest rates in June for the first time in over a year, it surprised the market by announcing two more rate hikes before the end of the year. Central banks are increasingly shifting their attention towards the labor market. Given historically low unemployment rates, the labor market continues to display resilience. Furthermore, the prevalence of numerous job openings signifies an ongoing shortage of workers, partly due to the lingering effects of the pandemic. This concern among central banks stems from the fear that wage growth will persist, thereby keeping the core inflation rate elevated. The core inflation rate in the US reached its peak of 6.6% last September but has only experienced a slight decline to 5.3% since then, persisting at a stubbornly high level.

The labor market, however, acts as a lagging economic indicator due to the time it takes for hiring and layoffs. Given the current tight labor market, companies may hesitate to let go of employees. This situation poses the risk that central banks, impacted by the stable labor market, may feel compelled to raise and maintain interest rates at high levels to reach their 2% inflation target, despite weakening economic prospects. The economic slowdown is already evident when taking a closer look at the declining purchasing manager indexes of the manufacturing sector. As a significant portion of interest rate increases occurred in the second half of last year, there is a possibility that the full impact of these rate hikes will only be felt in the coming months. The UK serves as a cautionary example, with the Bank of England facing the need to significantly raise interest rates due to persistent core inflation, even as they anticipate a substantial economic downturn. On top, households are increasingly facing financial pressure from rising mortgage rates and higher cost of living.

Global stock markets only partially reflect these risks. Despite this year's strong market performance of up to 13% for global equities, corporate earnings remain stagnant, leading to elevated valuations of the stock markets. Current valuations have surpassed the long-term average, which historically went hand in hand with periods of economic expansion and rising corporate profits. However, neither of these conditions is currently met. Additionally, return contributions for the current year are concentrated in a few technology sector stocks. At the same time, stock market volatility as measured by the VIX Volatility Index has reached the lowest level since the beginning of the pandemic. We see this as a sign that equity markets have only partially priced in the challenges mentioned.

Therefore, we maintain a defensive positioning by slightly underweighting our equity allocation. We continue to implement this by underweighting US equities. As central bank-controlled interest rates approach their peak levels, our preference remains with long-term government bonds and high-quality corporate bonds. We continue to avoid high-yield bonds as price levels do not appear attractive after a significant spread tightening.

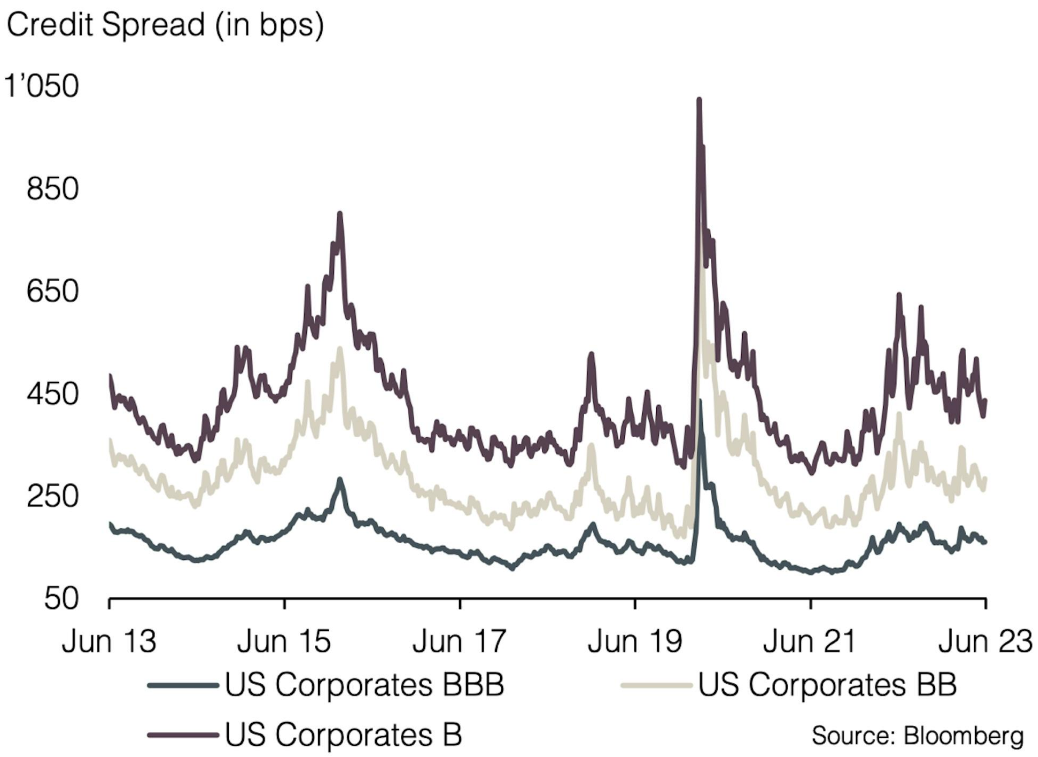
Spread between 2-year and 10-year US government bonds



Source: Bloomberg

Yields

The reaffirmation by central banks to continue fighting inflation has led to an increase in short-term interest rates. However, longer-term durations have remained practically unchanged due to concerns regarding economic growth. Consequently, the inversion of the yield curve has further intensified, indicating a looming economic slowdown. We still consider current interest rate levels attractive and prefer long-term government bonds and high-quality corporate bonds.



Spreads

Over the past month, credit spreads have tightened, particularly in the high-yield bond segment, making them appear unattractive. Credit spreads for high-risk bonds have fallen below the long-term average, providing only limited compensation in light of the current challenging economic situation. The segment has benefited from the fact that many low-rated companies had no refinancing needs. However, the longer interest rates remain at high levels, the greater the pressure is likely to be on the high-yield bond market as companies need to refinance their debt at much higher interest rate levels. As investors are currently inadequately compensated for holding high-yield bonds, the current price gains can be seen as an opportunity to reduce exposure in this area.

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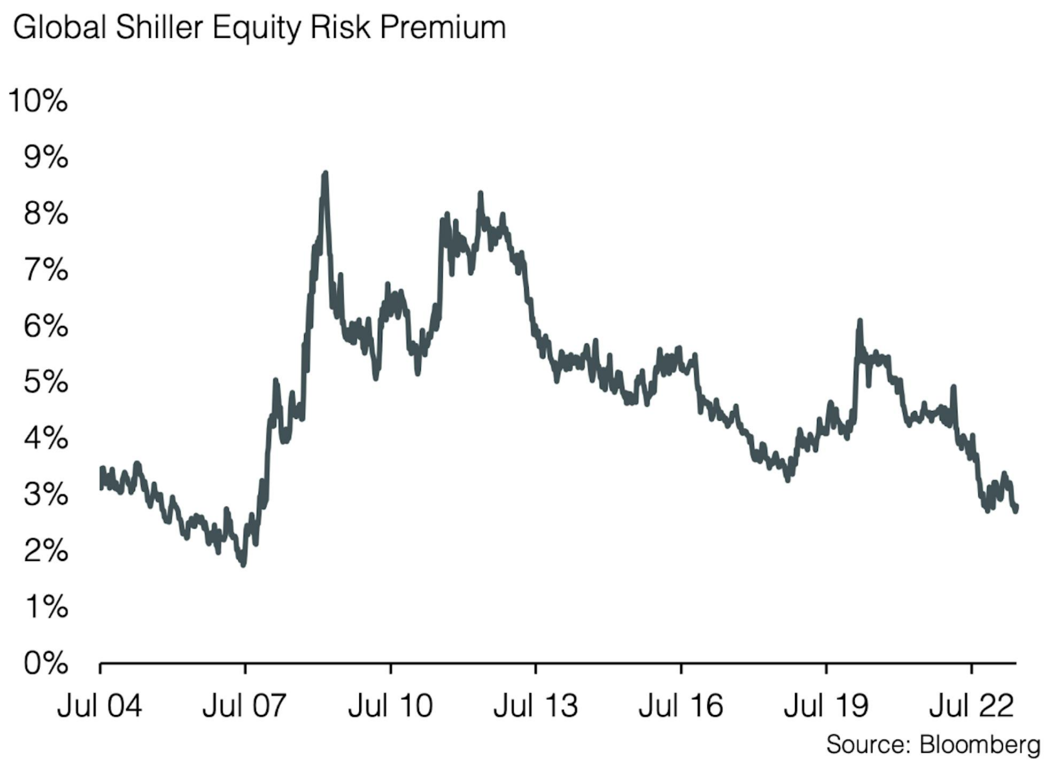
Unattractive

Attractive



Equity Risk Premium

As the rising stock prices did not go in lockstep with increasing corporate profits, the stock market has become more expensive. Consequently, the historical equity risk premium has declined over the past month to its lowest level since 2007, reaching a highly unattractive level.

Manufacturing PMI

	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	Mar 23	Apr 23	May 23	Jun 23
Global	54.1	54.2	54.2	54.3	53.2	53.7	53.0	52.3	52.3	52.2	51.1	50.3	49.8	49.4	48.8	48.7	49.1	49.9	49.6	49.6	49.6	
USA ISM	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	46.3	47.1	46.9	
Europe	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	47.3	45.8	44.8	43.6
United Kingdom	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	47.9	47.8	47.1	46.2
Switzerland	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	47.0	45.3	43.2	
China Local	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	51.9	49.2	48.8	
Japan	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	49.2	49.5	50.6	49.8

Services PMI

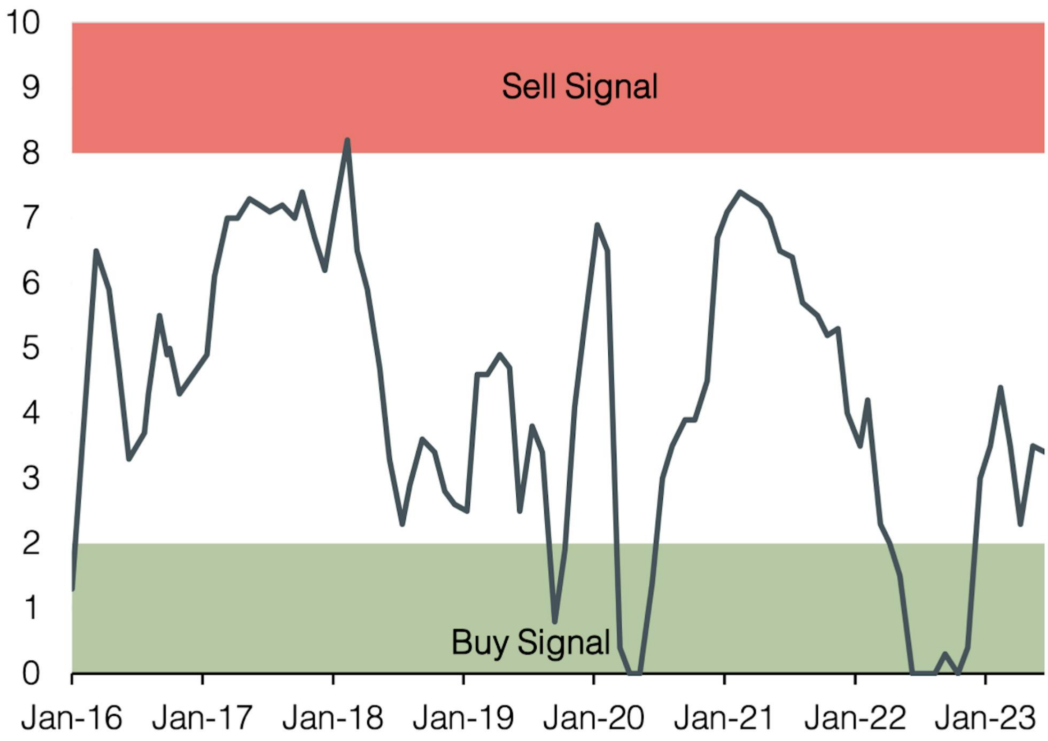
	Sep 21	Oct 21	Nov 21	Dec 21	Jan 22	Feb 22	Mar 22	Apr 22	May 22	Jun 22	Jul 22	Aug 22	Sep 22	Oct 22	Nov 22	Dec 22	Jan 23	Feb 23	Mar 23	Apr 23	May 23	Jun 23
Global	53.8	55.6	55.6	54.7	51.0	54.0	53.4	52.2	51.9	53.8	51.0	49.2	50.0	49.2	48.1	48.1	50.1	52.6	54.4	55.4	55.5	
USA ISM	62.1	66.6	67.6	61.7	60.4	57.2	58.4	57.5	56.4	56.0	56.4	56.1	55.9	54.5	55.5	49.2	55.2	55.1	51.2	51.9	50.3	
Eurozone	56.4	54.6	55.9	53.1	51.1	55.5	55.6	57.7	56.1	53.0	51.2	49.8	48.8	48.6	48.5	49.8	50.8	52.7	55.0	56.2	55.1	52.4
United Kingdom	55.4	59.1	58.5	53.6	54.1	60.5	62.6	58.9	53.4	54.3	52.6	50.9	50.0	48.8	48.8	49.9	48.7	53.5	52.9	55.9	55.2	53.7
Switzerland	60.9	59.3	59.2	59.9	56.4	64.3	61.1	56.2	59.6	58.1	55.6	56.6	52.8	53.8	53.4	49.5	56.7	55.3	54.2	52.2	52.6	
China Local	52.4	51.6	51.1	52.0	50.3	50.5	46.7	40.0	47.1	54.3	52.8	51.9	48.9	47.0	45.1	39.4	54.0	55.6	56.9	55.1	53.8	
Japan	47.8	50.7	53.0	52.1	47.6	44.2	49.4	50.7	52.6	54.0	50.3	49.5	52.2	53.2	50.3	51.1	52.3	54.0	55.0	55.4	55.9	54.2

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.

Leading Indicators

The purchasing manager indices in the manufacturing sector continue to weaken. In the services sector, there are also initial declines, but they remain above 50, indicating an expanding economy. The services sector is likely still benefiting from households' pent-up demand since the end of the pandemic. Overall, we maintain our neutral assessment.

Unattractive Attractive



Risk-Index

The risk index remains in the neutral range. Investor sentiment has improved since the beginning of the year, as reflected in the inflows into stocks. While investors still hold elevated cash reserves, there has been a noticeable decrease in recent months.

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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

Datasource: Bloomberg, BofA ML Research