

SoundInsight N°12

01

The global economy is cooling down

02

Bonds and stocks jump after positive inflation data

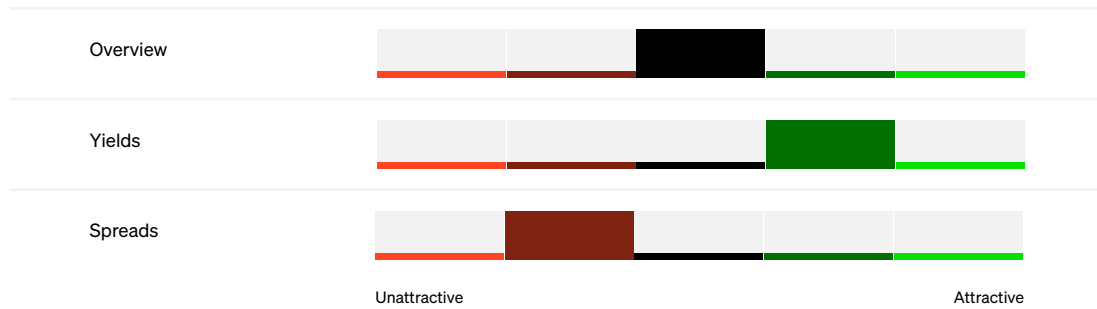
03

Soft-landing scenario remains doubtful

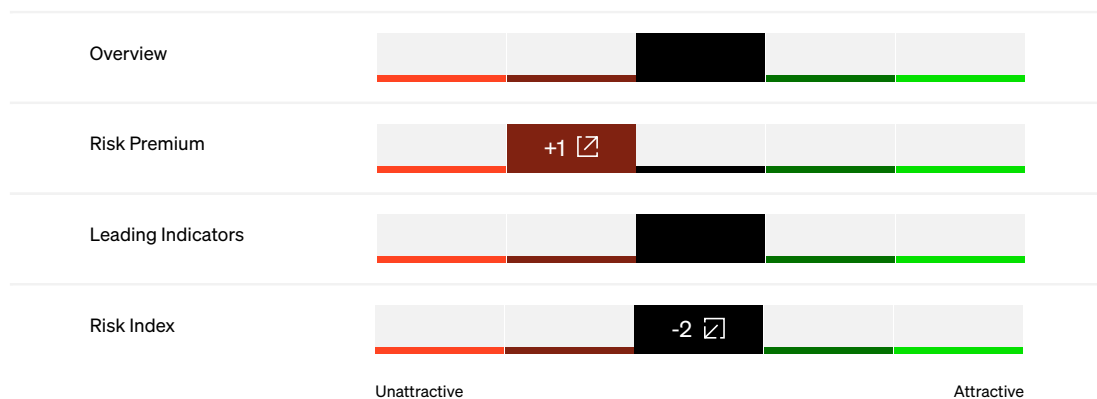
04

Consumer staples lifted to overweight

Bonds



Equities



Posted 11/28/2023 by Christian Luchsinger

Central Banks entering Home Stretch?

Financial markets responded with euphoria to declining inflation rates. So far, a simultaneous slowdown in the global economy keeps investors unbothered. The disparity between market expectations and central bank guidance once again poses potential tension.

The majority of economic data releases in the past month have sent a clear signal: The global economy is cooling down, and the central banks' battle against stubbornly high inflation appears to be successful.

One of the most reliable economic leading indicators in the United States, the ISM Manufacturing Purchasing Managers' Index, fell to 46.7 points last month, significantly missing economists' expectations of 49 points. In addition to the purchasing manager report, the acceleration of unit labor costs, the creation of new jobs, as well as the change in durable goods orders, also missed the expectation of economists. As a result, the overall number of positive economic surprises in the U.S., one of the main reasons for continuously high interest rates, has been consistently declining since peaking back in July. The overall softening trend in the economy was confirmed by the latest release of inflation data, which continues to trend lower faster than expected.

Consequently, investors now see central banks approaching the home stretch, with no further interest rate hikes expected in the current cycle. The focus is now shifting towards the first interest rate cuts, expected as early as May 2024. However, a sudden change in direction with regards to monetary policy is not on the menu for central bank officials. "My colleagues and I are pleased with the progress, but we expect that the process of sustainably lowering inflation to 2 percent is far from complete," said Jerome Powell at the beginning of the month. The positive development regarding inflation led to strong gains in both bond and equity markets. Due to significantly lower interest rates and a drop in inflation expectations, global bond markets experienced their strongest monthly increase in over 25 years. Equities, meanwhile, recorded the biggest monthly gain in three years. Unlike the earlier part of the year, gains in the equity space were broadly supported across sectors and styles and not solely carried by a few large companies.

SoundCapital™

While we see the decline in inflation as a positive development, the reason for it needs a closer analysis. Partially negative leading indicators and a declining U.S. consumption are currently accompanied by a slightly rising unemployment rate. Hence, there are reasons for doubt if the often-mentioned "soft landing" of the economy will pan out or whether high interest rates will ultimately trigger a recession.

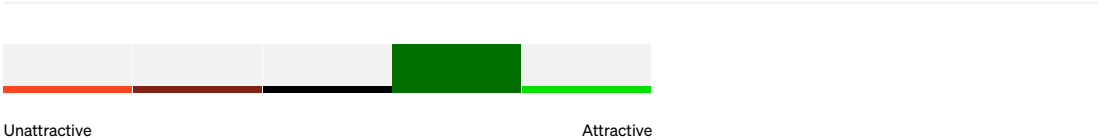
In the fixed income space, the current market development confirms our view, as we continue to recommend long-duration bonds from high-quality issuers. Due to unattractive credit spreads, we are avoiding the high-yield bond space for now. Emerging market bonds with investment grade credit ratings have lost attractiveness due to lower credit spreads and are now being reclassified to neutral. In the equity space, we were able to benefit from having increased the equity allocation last month. However, the risk index's buy signal has lately been neutralized by an improved sentiment. However, due to slight improvements in the equity risk premium as well as some leading indicators, the equity allocation remains at a neutral level. Within the neutral equity allocation, a cautious approach is warranted from our perspective. Therefore, we recommend focusing on companies with solid dividend growth, attractive valuation, and low leverage. We upgrade the consumer staples sector to overweight and downgrade the healthcare sector to neutral.

US 10y Treasury Yield

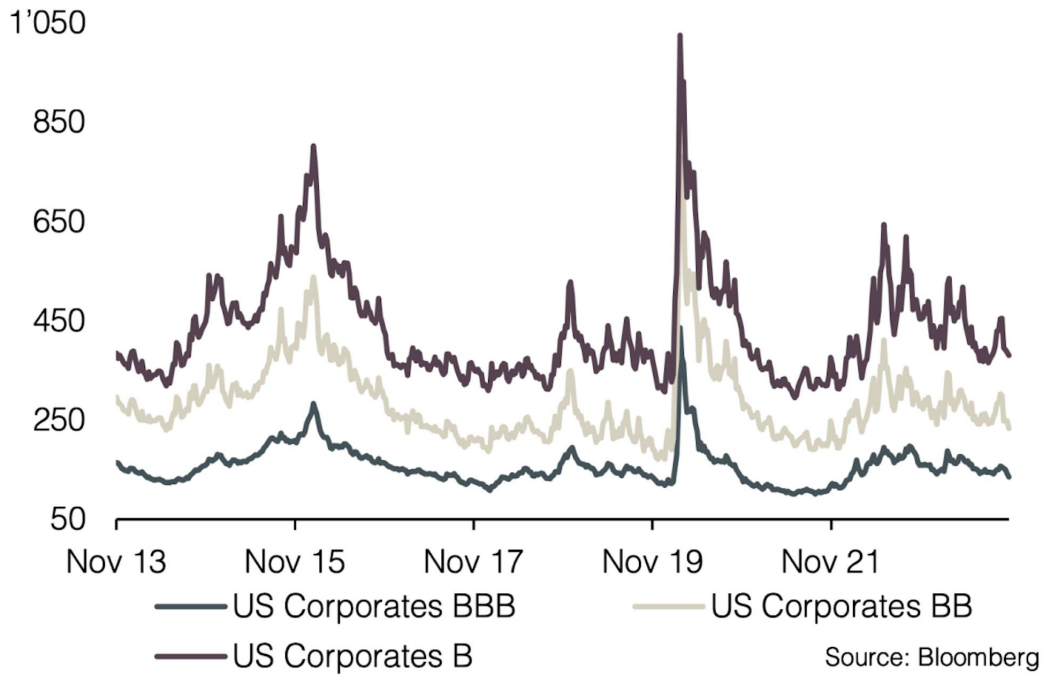


Yields

The interest rate swings in recent days highlight the significant positive effects that bond prices can have on a portfolio. 10-year U.S. Treasury bonds yields recently exceeded 5% but dropped to 4.36% in the aftermath of the inflation data release. The corresponding bond price gains for longer dated USD bonds are almost equity like and illustrate why it is worthwhile to lock in the currently attractive interest rates for an extended period.



Credit Spread (in bps)

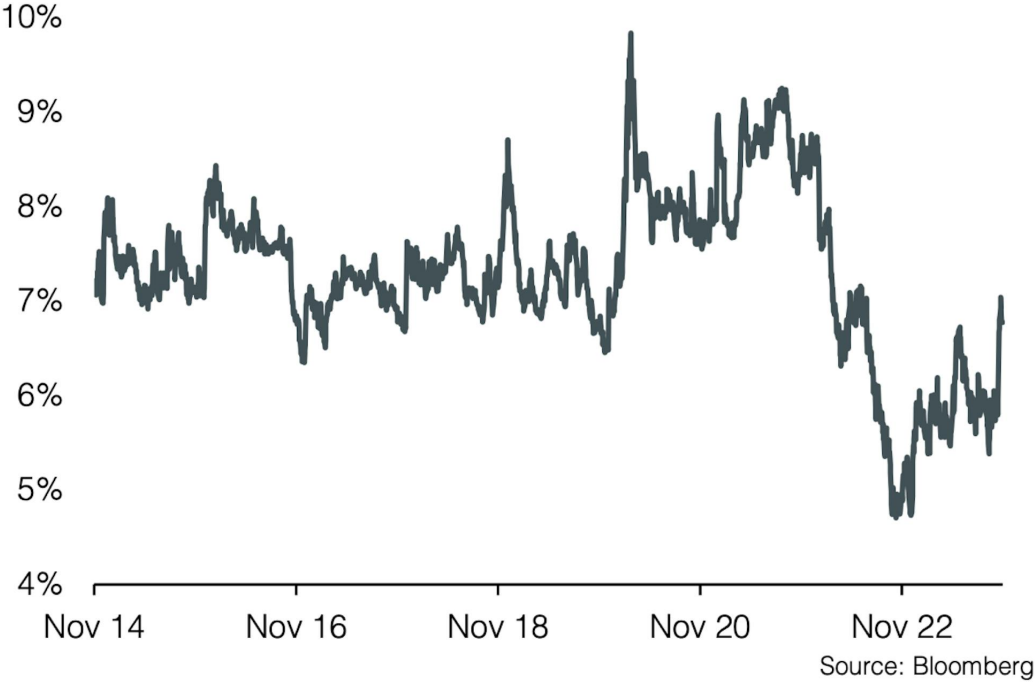


Spreads

The drop in inflation led to a generally increased risk appetite in the bond space. This also had a positive impact on less creditworthy borrowers, as their credit spreads narrowed, albeit remaining at still unattractive levels. We avoid investments with sub-investment-grade credit ratings and adhere to our preference for high quality borrowers.



Equity Risk Premium USA



Equity Risk Premium

The equity risk premium, based on the dividend discount model, has increased due to higher earnings estimates, attributed to improved expectation of analysts, particularly in the U.S. However, it goes without saying that there is a certain pro-cyclical alignment of analysts in this regard; nevertheless, for the first time in a while, expected equity risk premiums are moving to a more attractive level.



Manufacturing PMI

	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	Jul 23	Aug 23	Sep 23	Oct 23	Nov 23
Global	53.7	53.0	52.3	52.4	52.2	51.1	50.3	49.8	49.4	48.8	48.7	49.1	49.9	49.6	49.6	49.5	48.7	48.6	49.0	49.2	48.8	
USA ISM	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	46.0	46.4	47.6	49.0	46.7	
Europe	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	43.4	42.7	43.5	43.4	43.1	43.8
United Kingdom	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	46.5	45.3	43.0	44.3	44.8	46.7
Switzerland	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	44.9	38.5	39.9	44.9	40.6	
China Local	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	49.0	49.3	49.7	50.2	49.5	
Japan	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	49.6	49.6	48.5	48.7	48.1

Services PMI

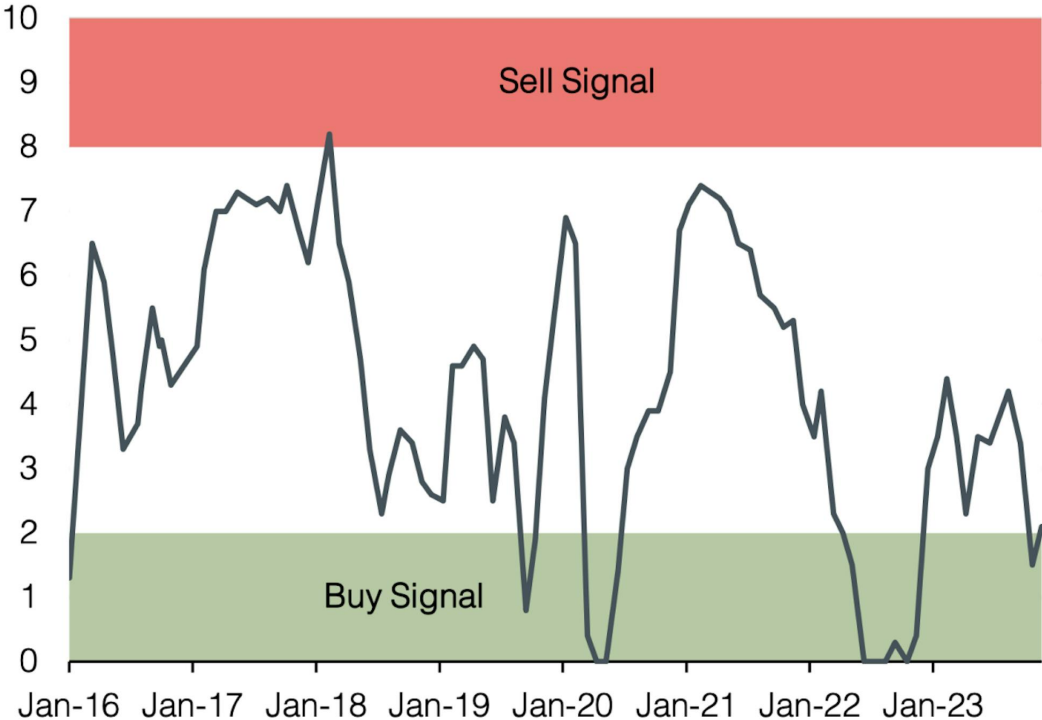
	Feb 22	Mar 22	Apr 22	May 22	Jun 22	Jul 22	Aug 22	Sep 22	Oct 22	Nov 22	Dec 22	Jan 23	Feb 23	Mar 23	Apr 23	May 23	Jun 23	Jul 23	Aug 23	Sep 23	Oct 23	Nov 23
Global	53.9	53.5	52.2	52.0	53.7	51.0	49.2	49.9	49.1	48.1	48.0	50.0	52.5	54.3	55.3	55.3	53.8	52.6	51.0	50.7	50.4	
USA ISM	57.2	58.4	57.5	56.4	56.0	56.4	56.1	55.9	54.5	55.5	49.2	55.2	55.1	51.2	51.9	50.3	53.9	52.7	54.5	53.6	51.8	
Eurozone	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	52.0	50.9	47.9	48.7	47.8	48.2
United Kingdom	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	51.5	49.5	49.3	49.5	50.5
Switzerland	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	49.6	42.7	50.3	52.8	52.2	
China Local	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	52.8	51.5	50.5	50.9	50.1	
Japan	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	54.0	53.8	54.3	53.8	51.6	51.7

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.

Leading Indicators

Leading indicators remain neutral. The anticipated turnaround in the manufacturing space has not materialized as the latest ISM report fell short of analyst expectations.





Risk-Index

The risk index has proven to be a valuable component of our indicators in recent weeks. Following the buy signal last month, both the bond and stock markets experienced positive returns. The strong market recovery has lifted the overall sentiment, resulting in a neutral assessment once again.



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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