Posted 10/30/2023 by Christian Luchsinger

# SoundInsight N°11

**01**

Longer dated US bond yield rise significantly

**02**

Falling money supply likely to curb inflation

**03**

Disappointing outlook from numerous companies

**04**

Equity weighting rises to Neutral due to negative sentiment

## Gloomy outlook unsettles investors

Long-term interest rates are experiencing a significant increase, which could trigger additional economic downside risks. A gloomy outlook from some companies is leading to heightened volatility, but it also presents opportunities in the stock market.

The rise in yields on long-term US government bonds, known as 'Bear Steepening', threatens the expected 'soft landing' of the economy, as it leads to further tightening of the already restrictive monetary policy. Although the yield curve is still inverted (with the yield on two-year Treasury-Notes remaining above the equivalent with a ten-year maturity), the extremely rapid increase in the yield on 10-year Treasury-Notes has reduced the yield spread versus 2-year Treasury-Notes from -1.1% at the middle of the year to now only -0.2%.

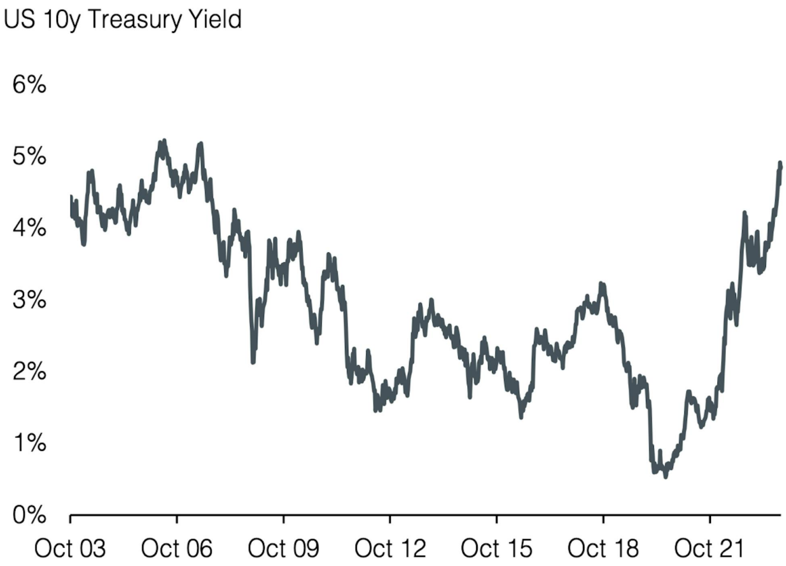
The specific reasons for this development are contentious. Long-term yields have certainly risen due to surprisingly positive economic data in the US, with GDP growing by 4.9% in the third quarter. Hence, economic growth significantly surpassed the expectations of most observers, including central bank policymakers. However, there are also negative factors driving yields higher such as the doubling of the US deficit by adding an additional trillion USD compared to the previous year. Furthermore, the rising issuance of bonds to cover an ever-increasing pile of debt causes investors to demand a higher premium to carry the risk associated with long-term bonds.

It's evident that rising costs are tightening financial conditions for mortgages and loans, leading to less investment and a subsequent decline in economic momentum. The negative shift in money supply confirms this trend: money has a challenging price again, and it will likely stay this way for the foreseeable future.

In the corporate world, this new reality is increasingly evident. While recent quarterly earnings results mostly exceeded analysts' expectations, a gloomy outlook has, in some cases, led to significant stock price declines. Alongside rising costs, especially affecting debt-fueled business models, a significant warning of declining consumer demand has been another reason for a currently disappointing earnings season.

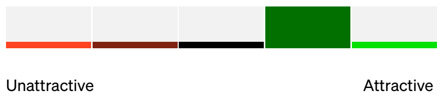
Despite these challenges, the global stock market has still shown substantial gains since the beginning of the year. However, it is widely known that a few heavyweight companies in the technology and communications sector have significantly distorted the overall returns. When considering an equal-weighted view, the same index has experienced a loss since the beginning of the year. Particularly, small caps, which often act as precursors for the general stock market, are performing poorly this year and posting high losses year-to-date.

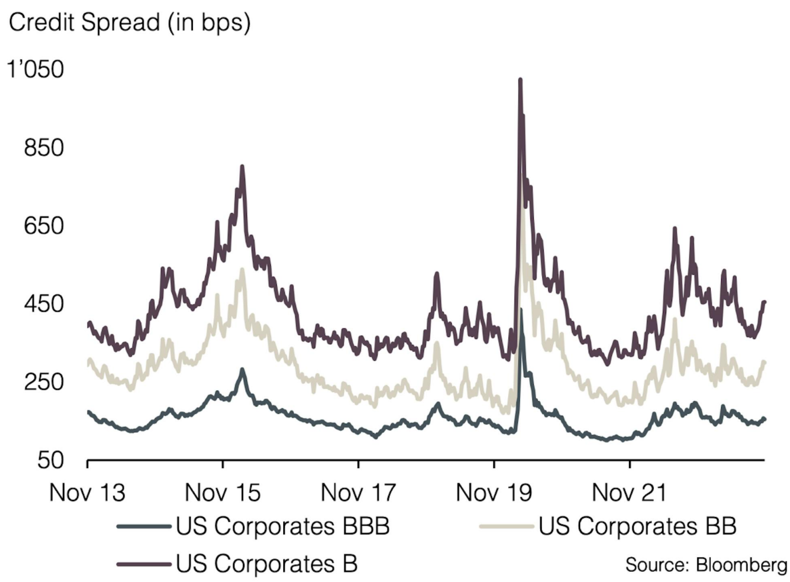
It's worth noting that currently more than 70% of companies in the S&P 500 are trading below their 200-day moving average. However, this situation also presents opportunities. Investor sentiment is as negative as it was during the turbulent May of 2022. Our factor model's contrarian risk index is signaling a counter-cyclical buy signal for the first time in a long while. Therefore, we are increasing our exposure to equities at the expense of liquidity, which leads to a neutral allocation of the asset class. In this market environment, it's highly recommended to continue focusing on quality and avoid substantially leveraged companies, as they are likely to face a significant increase in interest costs in the coming months. Due to the higher volatility in the stock market, we recommend a gradual increase in the equity allocation. Our preference remains with quality stocks offering attractive dividend yields, healthcare, and the energy sector. Overall, fundamental valuation levels are also coming back to the forefront in stock selection.




## Yields

An already attractive interest rate environment has seen further improvement in recent weeks. Carrying 5% yield, 10-year US Treasury bonds are now offering the highest yield since 2007. Furthermore, corporate bonds with an investment-grade rating are carrying a yield above 6.25% a level we haven't seen since the financial crisis back in 2008. It's noteworthy for investors that a yield of approximately 7.2% allows capital to double every 10 years. Therefore, high- quality bonds are likely to present an attractive investment opportunity for USD investors for the coming years.

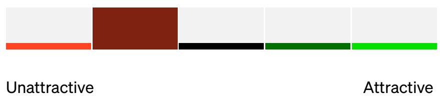



Source: Bloomberg

## Spreads

Falling stock prices due to pessimistic company outlooks have led to an increase in credit spreads in most markets. Currently, these spreads are still unattractive from a historical point of view. However, it's worth noting that a significant increase in credit spreads could result in an overweight position in fixed income.




# Equity Risk Premium

The equity risk premium remains unattractive, with high interest rates once again playing a significant role for the currently depressed level. Falling stock prices tend to lead to rising risk premiums. However, a significantly stronger downward movement in the stock market is required to achieve a more attractive valuation.

Unattractive Attractive

# Leading Indicators

Manufacturing PMI

| | 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 | Jul 23 | Aug 23 | Sep 23 | Oct 23 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Global | 53.2 | 53.8 | 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 | 49.1 | |
| USA ISM | 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 | 46.0 | 46.4 | 47.6 | 49.0 | |
| Europe | 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 | 43.4 | 42.7 | 43.5 | 43.4 | 43.0 |
| United Kingdom | 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 | 46.5 | 45.3 | 43.0 | 44.3 | 45.2 |
| Switzerland | 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 | 44.9 | 38.5 | 39.9 | 44.9 | |
| China Local | 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 | 49.0 | 49.3 | 49.7 | 50.2 | |
| Japan | 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 | 49.6 | 49.6 | 48.5 | 48.5 |

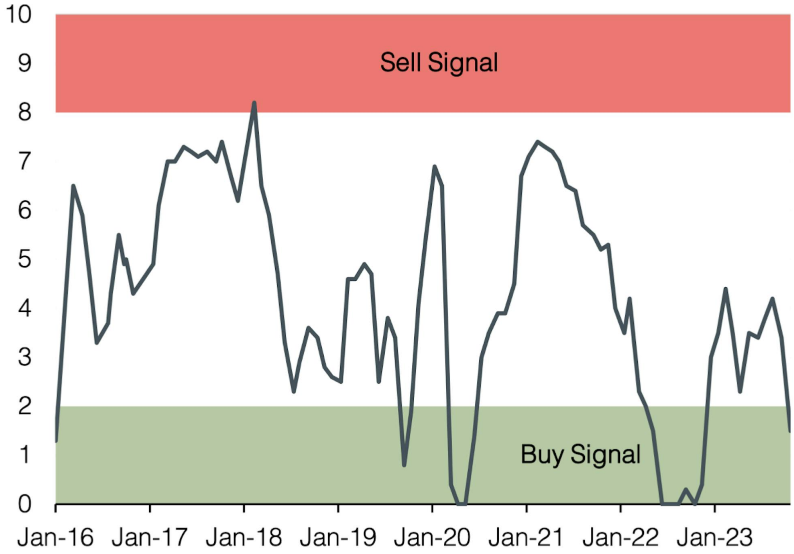
Services PMI

| | 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 | Jul 23 | Aug 23 | Sep 23 | Oct 23 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Global | 51.0 | 54.0 | 53.4 | 52.2 | 51.9 | 53.8 | 51.1 | 49.3 | 50.0 | 49.2 | 48.1 | 48.0 | 50.1 | 52.6 | 54.4 | 55.4 | 55.5 | 53.9 | 52.7 | 51.1 | 50.8 | |
| USA ISM | 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 | 53.9 | 52.7 | 54.5 | 53.6 | |
| Eurozone | 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 | 52.0 | 50.9 | 47.9 | 48.7 | 47.8 |
| United Kingdom | 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 | 51.5 | 49.5 | 49.3 | 49.2 |
| Switzerland | 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 | 49.6 | 42.7 | 50.3 | 52.8 | |
| China Local | 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 | 52.8 | 51.5 | 50.5 | 50.9 | |
| Japan | 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 | 54.0 | 53.8 | 54.3 | 53.8 | 51.1 |

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.

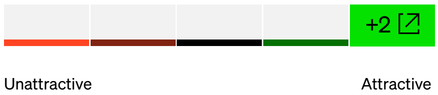
We have noticed a divergence in the performance of the service and manufacturing sectors for some time now. Currently, there is a growing disparity between the situations in Europe and the US. While leading indicators in Europe continue to show negative trends, data in the US appears to be trending positively once again. Nevertheless, there are numerous indicators suggesting that economic momentum is likely to decrease in the coming months, in the US as well.

Unattractive Attractive

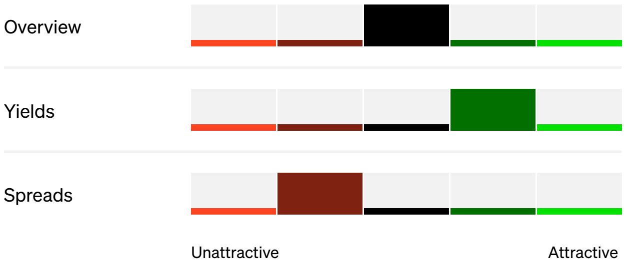



# Risk-Index

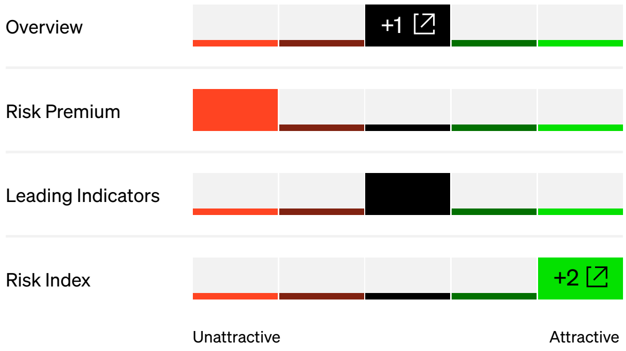
The contrarian risk index is showing a buy signal for the first time since May 2022. An analysis reveals that buy signals typically resulted in a positive performance over an extended period. Therefore, we are taking the opportunity to gradually increase the equity allocation to a neutral level.



## 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


Datasource: Bloomberg, BofA ML Research