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Investment Policy

Q2 2023 | March 2023

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Key points

Central banks: "higher for longer" and a potential newcomer

"Higher for longer" was the message on rates delivered by Fed chair Jay Powell in his Senate hearing earlier this month. He reiterated that taming **inflation** remains his **priority**. Ditto over at the European Central Bank and the Swiss National Bank.

Under pressure from the latest economic statistics, markets are at last listening to what rate-setters have been saying. Granted, there was some good news in the data at the end of last year regarding the speed at which consumer price growth was slowing. Sadly, the latest figures have been less reassuring (**chart 1**). At the same time, economic activity has been more resilient than expected.

Markets have therefore been forced to **revise** their peak-rate forecast **upwards** for the current tightening cycle. In the US, this is close to 5.5%, corresponding now to positive real interest rates by the summer, which would be truly restrictive for the economy. This is not yet the case in the Eurozone, where the peak is currently forecast around 4%. A further upward revision still seems likely. This outlook is reflected in longer-dated bond allocations in USD than in EUR or CHF, and in the prospect of the euro appreciating against the greenback. The **failure of Silicon Valley Bank** and the blanket deposit guarantee may temporarily dampen rate expectations but not knock the trend off course.

Meanwhile, the **Bank of Japan**, where Haruhiko Kuroda will be replaced by Kazuo Ueda as the next governor in April, could also join the ranks of central banks that are tightening monetary policy. Its current stance has become costly and less justified at a time when prices and wages are growing at 4% and 3.5% annually, respectively. Given the Bank of Japan's clout (its balance sheet is a whopping USD 5.6 trillion), a change of course on its part would contribute to reducing **global liquidity**, which in turn would moderate risk appetites and drive home the message that central banks are no longer on the side of markets.

Scenario and conclusions

- **Inflation** remains the priority for central banks
- Eurozone avoids **recession**...
- ...which is still waiting to happen in US
- **China** is back in business and picking up pace

→ **Equities**: underweight due to risks to top lines; preference for Europe and EMs over the US

→ **Bonds**: overweight (IG corporate bonds)

→ **Currencies**: exposure to USD and gold reduced. CHF still a favourite

→ **Cash**: overweight

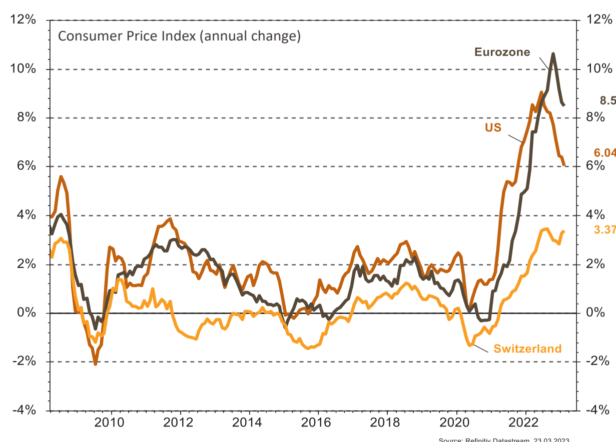
	UW (-)		N (=)		OW (+)
Asset allocation					
Equities		■			
Sovereign bonds		■			
Credit				■	
Alternative investments		■			
Cash					■
Equities					
US	■				
Europe				■	
Switzerland				■	
Japan		■			
Emerging markets				■	
Bonds					
Sovereign		■			
Corporate investment grade					■
High-yield corporate	■				
Emerging market sovereign (USD)	■				
Emerging market sovereign (local)	■				

Economy: *recession still waiting to happen in the US*

The **US economy** is holding up well. While many leading indicators are pointing to a recession, economic activity statistics are still consistent with solid quarter-on-quarter growth at an annual rate of around 2.6% (according to the Atlanta Fed's model). How can we account for this resilience, and why do we believe it is not sustainable?

In a recession, spending on durable goods, residential investment and business investment all contract. In the current cycle, we are already seeing a significant decline in **residential investment** (-19% y/y in Q4 2022), which is the item most sensitive to interest rate changes. Business investment remains strong (+4.3% y/y in Q4) for the time being. After reaching record post-pandemic levels, **profit margins** have been able to absorb the various cost increases (raw materials, labour, borrowing), but companies have not yet scaled back their development plans. But if margins were squeezed further, companies would undoubtedly become less ambitious. Moreover, leading economic indicators for the manufacturing sector are now in contraction territory, and industrial production rose by only 0.8% year-on-year in January. Consumer spending may be robust (+1.75% y/y in Q4) thanks to a strong labour market (517,000 jobs created in January and 311,000 in February), but this is also because of the excess savings accumulated during the pandemic. These have allowed households to absorb price increases without altering their spending habits. But savings will run dry by the end of the summer. From then onwards, only employment income will finance spending.

Chart 1 | Inflation: still too high!



But more than anything else, the effects of the Fed's **monetary tightening** – the fastest and most furious in history (+5% in 12 months) – are not yet fully visible. The SVB default is an early warning that tightening cycles are never pain-free. **Commercial banks** have tightened up the terms of lending for the private sector but this is yet to be reflected in loan volumes, which were up 11.5% year-on-year in January. Indeed, it usually takes a year for credit demand to ease. Expectations for a recession are also seen in the **inversion of the yield curve** (i.e. 10-year lower than 2-year yield), to a level not seen since 1981. Financial markets are pricing in future rate cuts, which will be necessary to stimulate economic activity after a period of contraction. For the time being, the US economy is still growing because of the delayed effect of monetary tightening but will run out of steam within 2-3 quarters.

For once, the **Eurozone** is for now in a better position. The energy crunch has not led to rationing. Admittedly, the high price of electricity has had a lasting impact on energy-intensive sectors (such as chemicals and metallurgy) and household consumption (-0.9% q/q), but a recession has been avoided (zero growth in Q4 compared with Q3 2022). And the good news is that the high level of gas reserves at the end of this winter should be fully replenished before the start of the next winter, without Russian supplies. As a result, we are seeing a recovery in manufacturing confidence indicators (**chart 2**). The outlook for corporate profit growth this year has been revised upwards (versus a downward

Financial markets

*) To 22.03.2023	Performance			Valuation			Earnings growth			
Equity markets	Price (local currency)	Quarter Q1*)	Since 31 Dec 2022	12-month P/EPS	Dividend yield	Price/ net assets	12-month EPS	2023 EPS	2024 EPS	2025 EPS
United States	3 738.96	2.71%	2.71%	17.58	2.2%	3.6	5%	1%	12%	12%
Europe	447.16	5.24%	5.24%	12.39	3.4%	1.8	3%	1%	7%	7%
Japan	1 962.93	3.80%	3.80%	12.38	2.6%	1.3	7%	6%	7%	8%
Switzerland	10 782.28	0.49%	0.49%	15.74	3.2%	3.1	22%	26%	13%	10%
United Kingdom	4 122.70	1.20%	1.20%	10.23	4.0%	1.7	-4%	-7%	4%	4%
Emerging Markets (USD)	961.48	0.53%	0.53%	11.39	3.4%	1.5	2%	-2%	16%	13%
World (USD)	2 686.13	3.21%	3.21%	15.60	2.6%	2.6	4%	1%	10%	10%

Source: Datastream, IBES consensus

revision for the US), which will be supportive of investment. The unemployment rate, which is at its lowest level (6.7%) since the creation of the single currency, will also support consumers. The European Council is planning in late March to discuss a **project to counter the US IRA** (Inflation Reduction Act), amid fears that the US scheme, which aims to speed up the energy transition by means of major tax breaks for companies, risks siphoning off a large part of green investment in Europe. Urgent action is therefore needed to avoid losing a whole wedge of European industry in the coming decades. The Maastricht budget criteria, suspended during the pandemic, will also have to be renegotiated, putting the North and the South (which includes France) back at loggerheads. Finally, as in the US, recent inflation stats beat expectations, with core inflation accelerating to 5.6% year-on-year. The ECB may therefore have to do more than expected to bring it back under control. The impact of monetary tightening on real estate is still modest, but prices are starting to fall in Germany and France.

Xi Jinping's historic third term as president of **China** has begun with a GDP growth target of 5% announced. While this figure may seem high, it is unambitious for the world's second-largest economy in post-opening acceleration phase. A better performance would also be a way of regaining some of the credibility lost in dealing with the pandemic.

In **Switzerland**, the CHF 132.5 bn loss on the **SNB**'s holdings and investments in 2022 will prevent it from distributing anything to anyone, but this upset is unlikely to distract from its main task of getting prices under control. Driven by services, the uptick to 3.4% year-on-year in February (+0.7% m/m) suggests that inflation is still ingrained and further rate hikes are probably in the pipeline, which will in turn support the Swiss franc.

Chart 2 | Manufacturing sector: improving in China and Germany but not in US

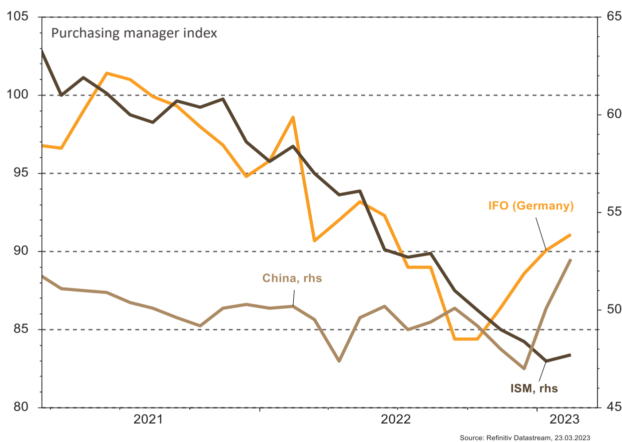
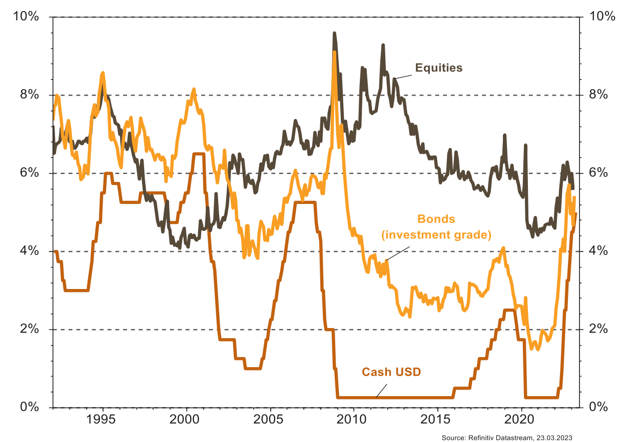


Chart 3 | Yield (USD): defensive assets offering attractive returns



10-year sovereign bonds	Level at 22.03.2023	Change Q1*) (bps)	Change since 31 Dec 2022 (bps)
USD yields – United States	3.45%	-38	-38
EUR yields – Germany	2.33%	-23	-23
JPY yields – Japan	0.33%	-8	-8
CHF yields – Switzerland	1.21%	-41	-41
GBP yields – United Kingdom	3.34%	-33	-33
Emerging markets (USD)	7.81%	9	9
Emerging markets (local currency)	4.28%	-14	-14
Commodities	**Price**	**Quarter Q1*)**	**Since 31 Dec 2022**
Gold (USD/oz)	1 946.39	7.2%	7.2%
Brent (USD/bl)	76.33	-11.0%	-11.0%

FX	Level at 22.03.2023	Change Q1*)	Change since 31 Dec 2022
EUR vs. CHF	0.9968	0.95%	0.95%
EUR vs. USD	1.0770	0.88%	0.88%
EUR vs. JPY	143.1762	1.67%	1.67%
EUR vs. NOK	11.3160	7.63%	7.63%
GBP vs. EUR	1.1324	0.42%	0.42%
GBP vs. USD	1.2231	1.68%	1.68%
USD vs. CHF	0.9237	-0.17%	-0.17%
USD vs. CAD	1.3723	1.28%	1.28%
AUD vs. USD	0.6686	-1.42%	-1.42%

Source: Datastream

Monetary preferences

Rank 1	Rank 2	Rank 3
Appreciation expected	Stabilisation	Depreciation expected
CHF | EUR	**JPY | NOK | USD**	**GBP | GOLD**
▪ **CHF**: interest rates are rising; safe haven currency and hedge against global inflation ▪ ↑ **EUR**: decline in political and energy risk should give currency a rerating	▪ **JPY**: very attractively valued; ditching the current loose monetary policy would be a catalyst ▪ **NOK**: has stabilised after oil price recovery ▪ **USD**: richly valued and favourable yield-spread move ending; still a hedge against a global downturn	▪ **GBP**: attractively valued but structural effects of Brexit are hurting growth potential; NI protocol reduces some near-term risks ▪ ↓ **GOLD**: current rates curb upside

Investment conclusions

The **return on cash** gives this risk-free asset par excellence a competitive advantage over others not seen for more than 20 years (**chart 3**). This is particularly true versus **gold**, which pays no coupon, which is why we have reduced its weighting in our allocation. However, we continue to use suitable structured products to generate returns on remaining positions, taking advantage of gold's high volatility.

Current sovereign long-term yields in the Eurozone and Switzerland (at their highest in over a decade) are starting to offer **opportunities**. While still reluctant to increase the average bond maturity in our portfolios, we are already recommending rolling over maturing bonds into longer-dated maturities (5-7 years). This is a first step towards a broader lengthening of duration in our bond portfolios in these currencies, mirroring the move already made in USD profiles. Within the bond universe, we continue to prefer **investment-grade debt**. We remain more cautious on high-yield paper, which is more exposed to souring economic conditions.

Uncertainty about future earnings – particularly in the US – is still poorly reflected in valuations, which justifies our broad underexposure to equities, especially US stocks. We have therefore continued to diversify away from the US and into **Europe**. European equities not only benefit from better growth dynamics but are also more affordable. This reallocation is correspondingly reducing our **dollar exposure**.

Publication date | **13 March 2023**

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