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Investment Policy

Q3 2023 | June 2023

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Key points

Will AI in 2023 be a rerun of the dotcom bubble in 2000?

The euphoria surrounding **artificial intelligence** (AI) in recent months is somewhat reminiscent of all the fizz and froth accompanying the emergence of the **dotcoms** in the late 1990s.

As we all know, the dotcoms started returning to earth in 2000 with the bursting of the stock market **bubble** that had been inflated in the preceding years. Alan Greenspan even spoke of "irrational exuberance" as far back as December 1996. So the question today is whether the current situation is comparable. Historically, for equity markets to go into overdrive, there must be a credible story – on which to base the investment case – and access to easy credit or abundant liquidity. In 2000, the **paradigm shift** was the advent of a new digital economy characterised by ubiquitous, strong, sustainable growth. And while it is true, just as promised, that our lives have changed since then, the usual laws of economics continue to apply. Back in 2000, valuations had become stretched to the point of insanity.

Right now, we still don't know whether a price bubble is forming. But we can be sure that AI is **no passing fad**. Look no further than the breakneck speed at which ChatGPT has been adopted, taking just two months to rack up 100 million users. By comparison, it took Uber 70 months to reach that milestone, Instagram 30 and TikTok 9.

A whole new ecosystem is emerging around the buzzwords "productivity" and "efficiency". But it could be **so disruptive** that roadblocks may be put in place to delay widespread adoption. Hundreds of experts around the globe are calling for a moratorium on AI supercomputer research, citing potential threats to humanity – even to our existence.

All in all, we advise investors to keep a cool head. Reduced **liquidity** – rather than stricter rules – would be more likely to dampen the ebullience of this nascent investment trend.

Scenario and conclusions

- **Inflation** remains too high (apart from in China) but is slowing
- Global **trend in monetary tightening** is nearing its end
- **US** is heading into a **recession**
- **China** disappoints but is likely to regain traction in H2

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

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

→ **Currencies**: CHF and EUR preferred to USD and GBP

→ **Cash**: overweight

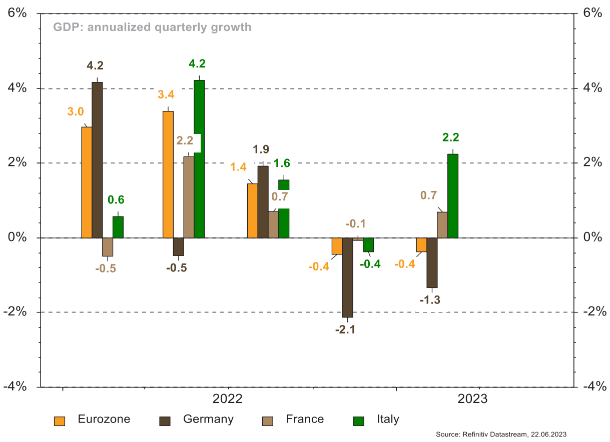
	UW (-)		N (=)		OW (+)
Asset allocation					
Equities		■			
Sovereign bonds		■			
Credit				■	
Alternative investments		■			
Cash					■
Equities					
US	■				
Europe				■	
Switzerland				■	
Japan		■			
Emerging markets				■	
Bonds					
Sovereign		■			
Corporate investment grade					■
High-yield corporate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

Economy: *America resilient but China falling short*

In the end, the **Eurozone** was unable to sidestep a **recession** this winter. After contracting by an annualised 0.4% q/q in the final quarter of 2022, economic activity continued to shrink at the same rate in Q1 2023. But the upset should be seen in perspective, because out of the Eurozone's major economies, only **Germany** posted negative growth in Q1 (annualised -1.3% q/q) (**chart 1**). Moreover, Germany's weak patch was entirely due to a negative contribution from consumer and government spending, which we believe is a one-off. The spike in energy costs that depressed household purchasing power is behind us, while the government is expected to pursue a more expansionary policy going forward.

All that said, the outlook for the European economy is not encouraging. The impact of the ECB's **monetary tightening** is beginning to be felt. Commercial banks have also tightened their lending conditions considerably. Unsurprisingly, it is the **property** sector that is bearing the brunt. In France, housing starts are down 10% from their January 2022 peak, while building permits have plummeted by 20% since last August. In Germany, the decline is 25% over 12 months. The fall in prices, which has so far been moderate, is set to continue.

Chart 1 | Eurozone: only recession-hit Germany has disappointed



The European **manufacturing sector** as a whole is also struggling. Leading indicators are sitting in contraction territory. For example, the manufacturing PMI fell from 54.6 to 44.8 on a 12-month basis in May, while industrial production contracted by 2% over the period. On a more positive note, the services sector – driven by household spending – continues to expand for the foreseeable future, as evidenced by the correspondingly high PMI of 55.1 in May. Strong household demand can be explained by the shift in consumer preferences towards services in the wake of the pandemic, as well as by accumulated **excess savings**, still estimated at 7.5% of GDP, and a tight labour market, with the unemployment rate falling further to 6.5% in April. Admittedly, the wage increases associated with full employment are not making the ECB's job any easier. Wage settlements in the Eurozone show an increase of 4.3% year-on-year. But it can at least be pleased that inflation has slowed sharply, from over 10% year-on-year in October to 6.1% in April. With the rate on the deposit facility much lower (at 3.5% in June), the ECB may need to tighten further to bring price growth back under control.

The **Fed** seems closer to ending its tightening cycle. The 25bp hike expected in June or July might even be the last. With 12-month **inflation** slowing to 4.1% in May and the short-term interest rate at 5.25%, monetary policy has become restrictive, seeing that real rates are positive. Regional bank failures are part of the collateral damage of this new order. Added to that, the revised tougher lending terms by commercial banks are now compatible with a **recession** between now and the end of the year (or possibly creeping into 2024), which justifies the Fed hitting the pause button. As in Europe, property and manufacturing are in recession but services are holding up well, helped by continued strong job creation (1,570 million in 2023, including 339,000 in

Financial markets

***) To 21.06.2023**	Performance			Valuation			Earnings growth			
Equity markets	Price (local currency)	Quarter Q2*)	Since 31 Dec 2022	12-month P/EPS	Dividend yield	Price/ net assets	12-month EPS	2023 EPS	2024 EPS	2025 EPS
United States	4 146.70	6.19%	13.90%	19.36	2.0%	4.2	7%	1%	11%	12%
Europe	457.01	-0.18%	7.56%	12.38	3.3%	1.9	3%	0%	7%	8%
Japan	2 295.01	15.00%	21.00%	14.17	2.3%	1.3	9%	9%	8%	9%
Switzerland	11 173.65	0.61%	4.10%	15.91	3.1%	3.7	9%	9%	9%	8%
United Kingdom	4 115.41	-1.00%	0.99%	10.36	3.9%	1.6	-2%	-8%	4%	5%
Emerging Markets (USD)	1 004.27	1.41%	5.01%	12.30	3.5%	1.6	8%	-2%	18%	13%
World (USD)	2 927.72	4.88%	12.50%	16.89	2.5%	2.9	6%	1%	9%	10%

Source: Datastream, IBES consensus

May). However, the spending boost from savings built up during the pandemic is slowing and will run dry by the end of the year. Similarly, while outstanding loans have not yet fallen, the higher cost of debt is evident, with the proportion of household spending devoted to interest payments rising sharply to over 3% from less than 1% a year ago. The non-manufacturing PMI – an indicator of business confidence – reflects these tougher times, after falling from 55.2 at the start of the year to just 50.3, close to the contraction threshold. Ultimately, the US economy is contracting at a slower pace than initially thought, but it will be hard to avoid a recession, judging by PMIs, none of which point to an upturn (**chart 2**). And while the raising of the debt ceiling comes as a relief, the bipartisan deal freezes public spending until January 2025.

China's recovery is proving less energetic than hoped for. Like elsewhere in the wake of the pandemic, spending on services is the main driver, much to the detriment of investment and manufacturing. Even so, Beijing is in a relatively comfortable position. With inflation under control (+0.2% y/y), the PBoC can ease monetary conditions to galvanise economic activity. Disappointment with the pace of the recovery is prompting the Chinese government to take selective measures for the beleaguered property sector, which is particularly important for overall economic activity. This breathing space for the government points to a re-acceleration in growth during the second half of the year.

In **Switzerland**, GDP growth in the first quarter was better than expected (+0.3% q/q), fuelled by brisk spending (+0.6% q/q) and investment (+2.6% q/q), while construction stagnated (-0.1%). So did public spending. Inflation slowed to 2.2% year-on-year in May, close to the SNB's target. The peak in interest rates is definitely nearby. Incidentally, the SNB reported a profit of CHF 26.9bn in Q1.

Chart 2 | US PMIs: no improvement in sight

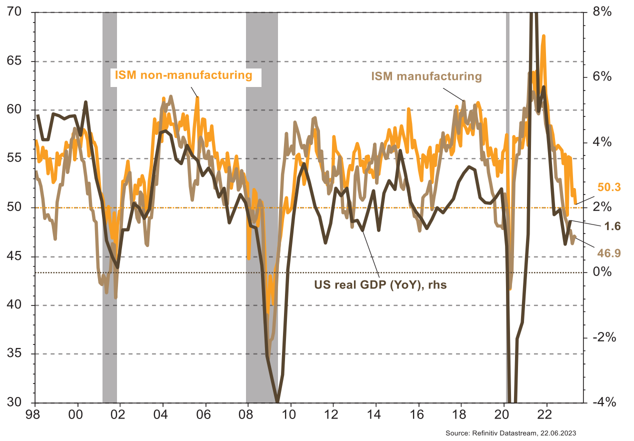
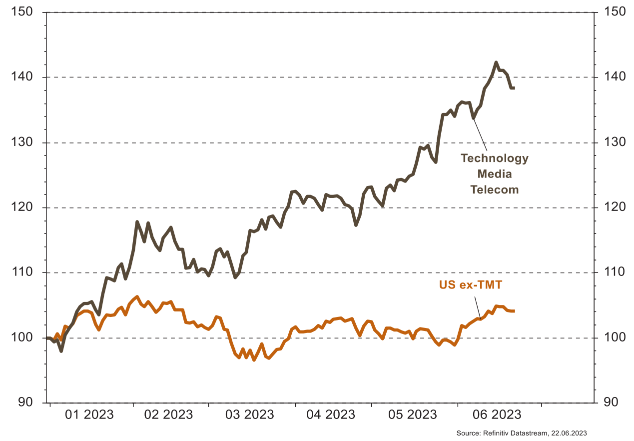


Chart 3 | US equities: indices flat year to date without tech



10-year sovereign bonds	Level at 21.06.2023	Change Q2*) (bps)	Change since 31 Dec 2022 (bps)
USD yields – United States	3.72%	24	-11
EUR yields – Germany	2.43%	13	-13
JPY yields – Japan	0.38%	5	-4
CHF yields – Switzerland	1.00%	-22	-62
GBP yields – United Kingdom	4.40%	103	74
Emerging markets (USD)	7.64%	-3	-8
Emerging markets (local currency)	4.31%	1	-11
Commodities	**Price**	**Quarter Q2*)**	**Since 31 Dec 2022**
Gold (USD/oz)	1 930.20	-2.3%	6.3%
Brent (USD/bl)	77.16	-3.0%	-10.0%

FX	Level at 21.06.2023	Change Q2*)	Change since 31 Dec 2022
EUR vs. CHF	0.9806	-1.20%	-0.69%
EUR vs. USD	1.0955	0.79%	2.62%
EUR vs. JPY	155.5994	7.61%	10.50%
EUR vs. NOK	11.7085	2.90%	11.37%
GBP vs. EUR	1.1682	2.70%	3.59%
GBP vs. USD	1.2732	2.97%	5.84%
USD vs. CHF	0.8951	-2.02%	-3.25%
USD vs. CAD	1.3181	-2.61%	-2.72%
AUD vs. USD	0.6771	1.10%	-0.15%

Source: Datastream

Monetary preferences

Rank 1	Rank 2	Rank 3
Appreciation expected	Stabilisation	Depreciation expected
CHF | EUR	JPY | NOK | USD	GBP | GOLD
▪ **CHF**: is a haven currency and hedge against global inflation; no longer overvalued ▪ **EUR**: attractively valued and respectable growth momentum	▪ **JPY**: attractively valued after sharp depreciation; ditching the current loose monetary policy would be a catalyst ▪ **NOK**: diversification play, correlated with the price of oil ▪ **USD**: richly valued and end of spread-widening move works in its favour; still a reliable hedge against a global slowdown in economic activity	▪ **GBP**: attractively valued but structural effects of Brexit due to have a lasting negative impact on growth potential ▪ **GOLD**: real interest rates are curbing upside

Investment conclusions

The US is ahead of the curve in its monetary cycle. The level reached by long-term sovereign yields has enabled us to **lengthen the duration** of our USD bond portfolio. In EUR and CHF, returns on long-dated maturities are still too paltry for us to make the same adjustment. In all currencies, we maintain a preference for high-grade corporate bonds with extra yield above past averages.

Equities are still vulnerable to a slowdown in economic activity. In the past, investors who bought into the end of central bank tightening cycles have come unstuck, as this tends to signal that borrowing costs have become sufficiently tight and a recession is imminent. The end of the tightening trend also suggests that the returns offered by fixed-income assets, including cash, are a profitable defensive alternative.

We therefore remain underweight this asset class, particularly in the US, where the relative valuation of equities is the least attractive. The performance of US indices has been driven solely by the buzz surrounding AI. Without the '**magnificent seven**' (of tech giants), the S&P 500 (+11%) would be flat year to date (**chart 3**). This cluster effect is a source of vulnerability for the US market. Our overweight in emerging markets has disappointed, but our investment case based on low valuations and stronger growth prospects is intact. We are maintaining our exposure.

Within **currencies**, our preference for the CHF and the EUR remains unchanged. The US dollar's excess return over other currencies is set to diminish. The greenback clearly no longer deserves its premium.

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