

Investment Policy

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Key points

Inflation: a victory for central banks?

Price growth is slowing faster than initially thought. In the **US**, inflation fell from its peak of 9.1% in June 2022 to 3.2% in July. In the **Eurozone**, it slowed from 10.6% in October 2022 to 5.3% in August 2023. In both cases, inflation is still above the central bank target of 2%. In **Switzerland**, inflation slowed from 3.4% in January to 1.5% in August, within the 0-2% range set by the Swiss National Bank (SNB) – largely thanks to appreciation in the Swiss franc, which has been keeping a lid on imported inflation. It therefore looks like the end of the road for the **SNB's** rate hikes, although increases in electricity prices (+18% on average), inflation-indexed rents and VAT (standard rate rising from 7.7% to 8.1%) are likely to complicate matters from next year.

At this stage, the slowdown in inflation can be chiefly explained by two factors. The first is the **fall in demand** for manufactured goods, which had risen sharply during the pandemic, leading to significant increases in production, transport and logistics costs. Since then, global manufacturing has been in recession. Prices have even fallen in China, which remains heavily dependent on manufacturing. The second factor is **base effects**, which played a major role in the first half of the year following the Ukraine-related spike in energy prices in 2022. As the guardians of price stability, central banks have been tightening monetary policy, which have become restrictive – so much so that in the US, real interest rates have swung positive. This policy is also dampening business activity in the hitherto buoyant services sector, helping to avoid the repeated wage increases that could fuel an inflationary spiral (**Chart 1**).

Even if some inflationary blips are to be expected in the coming months, the **work of central banks** is largely done. But there won't be an immediate easing of monetary policy.

Scenario and conclusions

- Rising oil prices are disrupting the inflation trajectory
- US has so far been resilient but is heading for recession
- Chinese authorities are working round the clock to save economy

- **Equities:** underweight due to risk to top lines; rotating into Japan out of China
- **Bonds:** overweight (IG corporate bonds)
- **Currencies:** preference for CHF and EUR over USD and GBP
- **Cash:** overweight

Asset allocation

	UW (-)	N (=)	OW (+)
Equities	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Sovereign bonds	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Credit	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Alternative investments	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Cash	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Equities			
US	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Europe	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Switzerland	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Japan	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Emerging markets	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Bonds			
Sovereign	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Corporate investment grade	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
High-yield corporate	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Emerging market sovereign (USD)	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Emerging market sovereign (local)	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Economy: US resistance, Chinese recovery and European weakness

US GDP grew by 2.1% (q/q annualised) in Q2, spurred on by consumer spending. But the biggest boost came from business investment, which has perked up after several quarters of detracting from growth figures.

In contrast, weak demand has dragged US **manufacturing** into a recession. Industrial production is down slightly year-on-year (-0.2% according to latest figures) while leading indicators – though showing initial signs of stabilisation – are still in contraction territory (ISM and S&P manufacturing PMIs at 47.6 and 47.9, respectively). **Services** are holding up, but with divergent signs from leading indicators, which in turn clouds the picture. The ISM services PMI rebounded to 54.5 in August, but the S&P's counterpart weakened to 50.5, perilously close to contraction territory (threshold of 50).

More generally, we don't think that the full impact of the Fed's tightening is visible. The **property** sector, both residential and commercial, is so far the only part of the economy that has been affected – by a direct hit from higher mortgage rates (which have risen from 2.7% in late 2020 to almost 7%). For the time being, the short-

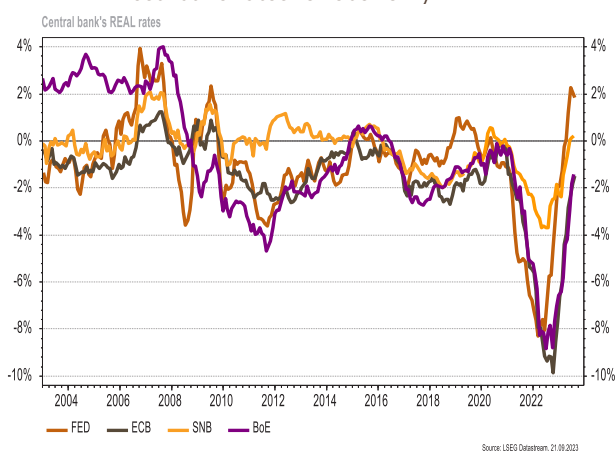
age of properties for sale is capping the fall in prices in the residential segment (down just 1% since the May 2022 peak). But home affordability is at its lowest level since 2005, and this will not improve unless prices fall and borrowing becomes cheaper, neither of which is likely to happen any time soon. In contrast, commercial property prices have fallen more sharply (-10%).

In addition, **surplus household** savings are likely to run dry by the end of the year. From that point onwards, households will have to rely solely on earned income to finance spending. The labour market is showing initial signs of weakening, though is not yet in free fall. The pace of job creations is slowing, with the three-month average falling below 200,000 per month and the unemployment rate rising from 3.5% to 3.8% (**Chart 2**). We are also seeing a resurgence in consumer credit defaults, indicating that households are now struggling to make ends meet.

Loosening the **fiscal purse strings is not an option** any more either, following Fitch's decision to downgrade the country's credit rating, bringing itself into line with S&P (which did the same back in 2011).

Economic activity in the **Eurozone** remains sluggish, with some regions performing better than others. Worst of all, we see no signs of improvement. Overall growth in the Eurozone was 0.5% (q/q annualised) in the second quarter of 2023, with France (+2.1%) outperforming Germany (barely +0.1%, after two quarters of contraction) and Italy (-1.6%), both of which are more exposed to manufacturing. The Eurozone manufacturing PMI was stable in August, edging up to 43.5 from 42.7 in July, but still in contraction territory. Even in the services sector, confidence as measured by the PMI fell below the 50 threshold to 47.9 in August, suggesting that services are not coming to the rescue (**Chart 3**).

Chart 1 | Central banks: attractive rates for investors, restrictive rates for economy



Financial markets

*) To 20.09.2023

Equity markets	Performance			Valuation			Earnings growth			
	Price (local currency)	Quarter Q3*)	Since 31 Dec 2022	12-month P/EPS	Dividend yield	Price/net assets	12-month EPS	2023 EPS	2024 EPS	2025 EPS
United States	4 188.03	-0.96%	15.00%	19.15	2.0%	4.3	10%	2%	12%	13%
Europe	460.66	-0.28%	8.42%	12.08	3.4%	1.8	5%	-1%	7%	8%
Japan	2 406.00	5.10%	27.00%	14.17	2.2%	1.4	10%	13%	7%	9%
Switzerland	11 154.11	-1.10%	4.00%	15.69	3.2%	3.7	10%	5%	11%	10%
United Kingdom	4 197.78	2.50%	3.00%	10.39	3.9%	1.6	0%	-11%	5%	6%
Emerging Markets (USD)	970.87	-1.88%	1.52%	11.83	3.4%	1.6	13%	-4%	18%	14%
World (USD)	2 936.36	-1.02%	12.80%	16.76	2.4%	3.0	8%	1%	10%	11%

Source: Datastream, IBES consensus

In **Switzerland**, the SNB is the only entity with something to celebrate. By pulling monetary and exchange rate levers, it has succeeded in bringing inflation (+1.5%) back within its target range (0-2%) before any other central bank. In contrast, purchasing managers in the manufacturing sector are looking glum, with a confidence level of just 39.9 – on a par with the pandemic low of March 2020. In addition, household spending power will be eroded by the new-year increases in VAT, electricity prices, health insurance premiums and, for some, rent. There is no doubt that **purchasing power** will be a key issue in the upcoming elections.

The **Chinese economy** is dashing hopes. Its traditional growth engines – manufacturing and the property sector – have both stalled. It is suffering more than others from the global manufacturing recession and also from a property market crippled by the over-indebtedness of many developers. From an economic point of view, a turnaround in manufacturing activity may be possible over the next few months, but a recovery in the property sector seems more distant. The authorities must

succeed in reassuring households, whose confidence was initially shaken by management of the pandemic and now by problems in the property market. Measures taken so far by the government mark a step in the right direction, making it easier for people to afford a home, encouraging green investment and reducing the tax burden. But this will not be enough to revive consumer spending any time soon. The People’s Bank of China, in particular, has room to go further in supporting the government’s stimulus, by easing monetary policy in the absence of inflation. So far, cuts in banks’ reserve requirements and borrowing costs have been too timid to stimulate demand.

Oil-producing countries, led by Saudi Arabia, are stepping up efforts to keep the price of crude high, leading to production cuts over the summer. The resulting rise has already exceeded 20% since the start of the quarter. The implications are far reaching. Obviously, the news is bad for purchasing power and is not making the work of central banks in combating inflation any easier.

Chart 2 | US: downtrend in job creations, but not in free fall

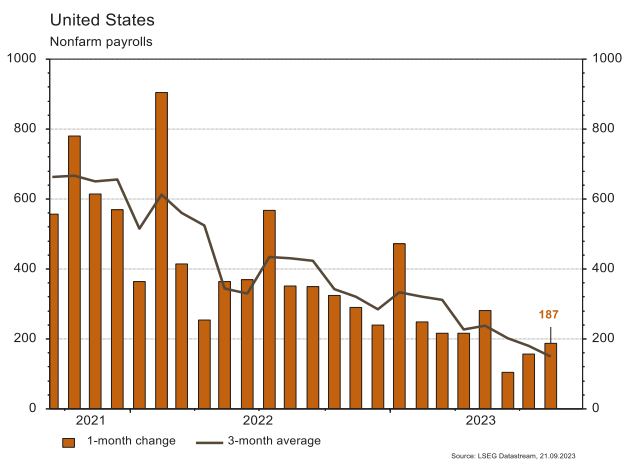
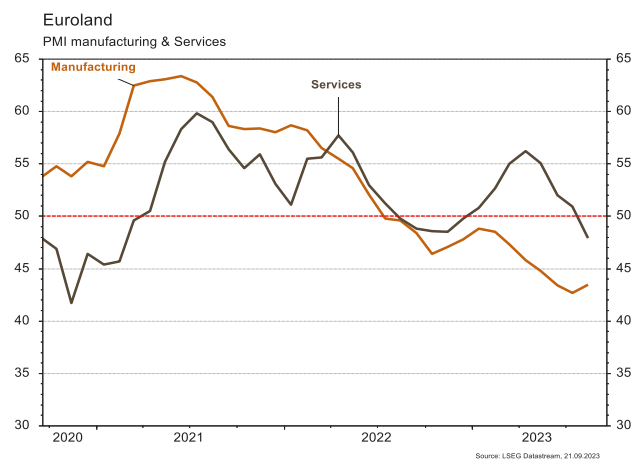


Chart 3 | Eurozone: deterioration in purchasing manager confidence widespread



10-year sovereign bonds	Level at 20.09.2023	Change Q3*) (bps)	Change since 31 Dec 2022 (bps)
USD yields – United States	4.37%	56	54
EUR yields – Germany	2.68%	29	12
JPY yields – Japan	0.71%	31	30
CHF yields – Switzerland	1.10%	14	-52
GBP yields – United Kingdom	4.22%	-17	55
Emerging markets (USD)	8.02%	34	30
Emerging markets (local currency)	4.40%	13	-2

Commodities	Price	Quarter Q3*)	Since 31 Dec 2022
Gold (USD/oz)	1 945.35	1.5%	7.1%
Brent (USD/bl)	92.35	24.0%	7.5%

FX	Level at 20.09.2023	Change Q3*)	Change since 31 Dec 2022
EUR vs. CHF	0.9589	-1.76%	-2.89%
EUR vs. USD	1.0689	-2.02%	0.13%
EUR vs. JPY	158.3217	0.40%	12.43%
EUR vs. NOK	11.4725	-1.85%	9.12%
GBP vs. EUR	1.1601	-0.45%	2.87%
GBP vs. USD	1.2399	-2.47%	3.08%
USD vs. CHF	0.8946	-0.01%	-3.31%
USD vs. CAD	1.3411	1.35%	-1.03%
AUD vs. USD	0.6498	-2.39%	-4.19%

Source: Datastream

Monetary preferences

Rank 1 Appreciation expected CHF EUR	Rank 2 Stabilisation JPY NOK USD	Rank 3 Depreciation expected GBP GOLD
<ul style="list-style-type: none"> ▪ CHF: a safe-haven currency and a hedge against global inflation; no longer overvalued ▪ EUR: attractively valued but growth momentum deteriorating 	<ul style="list-style-type: none"> ▪ 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 	<ul style="list-style-type: none"> ▪ GBP: attractively valued but structural effects of Brexit are hurting growth potential ▪ GOLD: real interest rates are curbing upside

Investment conclusions

Higher sovereign yields in the Eurozone have enabled us to extend the average maturity of our bond portfolios, which is now in line with benchmarks – as was already the case for US government bonds. In Switzerland, the uptrend has been less pronounced and we consider the level reached so far insufficient to make the same adjustment in Swiss francs. Within the bond space, our preference still lies with high-grade corporate bonds, to which we have **increased our exposure** at the expense of hedge funds, which have become less attractive from a yield angle.

We see **equities** in general, and US equities in particular, as vulnerable for two reasons. The first is that we believe the outlook for earnings growth is excessive if indeed – as we expect – the economy continues to slow over the next few quarters. The second is that there

are now more defensive **alternatives** to equities, such as bonds and even term deposits. We therefore retain our underweight in this asset class, although having rejigged our regional allocation. Exposure to Japan has been increased at the expense of China. The Japanese economy’s emergence from deflation should lead to a revaluation of all these assets, while in China disappointments are mounting and confidence among foreign investors is waning.

We are holding a significant proportion of **cash** at good rates of return, with a view to seizing any opportunities that may arise in the coming months.

Finally, in terms of **currencies**, we favour the Swiss franc. The US dollar is holding up well against the euro but is too richly valued.

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