BELVÉDÈRE
Asset Management

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INTEREST MAGIC

MARKET INSIGHTS

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The term insight stands for an in-depth understanding of the true nature of a situation, taking into account all its complexity. This should give you an idea what you may expect from our new investment publication Market Insights, which you are holding in your hands or reading on your screen for the first time today: A deeper look into current market events as well as an outlook of how financial markets are likely to evolve over the weeks and months ahead.

For instance, until recently, we were witnessing unthinkable moves in monetary policy. At the beginning of the year, the majority of market observers assumed that the European Central Bank (ECB) and – along with it – the Swiss National Bank (SNB) would not raise interest rates. However, in mid-June, the SNB surprisingly went ahead with an interest rate hike. And the consensus is now that the ECB will almost certainly raise interest rates, too, for the first time in eleven years at its next meeting on 21st July. Further interest rate hikes will follow.

Why the sudden rush? The simple answer is inflation. It continues to rise from an already high level due to the price distortions in the wake of the Ukraine conflict and is now driving the central banks to tighten their policies. The trouble is that interest rate hikes are utterly useless in stemming the prevailing inflation drift. This may sound a bit harsh. We need to understand though that the current price hikes are not, or only to a minor extent, owed to strong demand, but are rather driven primarily by supply chain disruptions, lockdowns in China, energy shortages, the Ukraine conflict, sanctions. And none of these factors will be remedied by higher interest rates.

So this is all just a waste of time and effort, is it? By no means! The interest rate steps the monetary institutions are now conjuring out of the hat – Interest Magic style – are appropriate and relevant. Negative interest rates cast a burden on the system, affecting almost everyone – savers and investors, pension funds and life insurers, banks etc. Ending this regime and bringing about a normalisation of the interest rate levels makes sense. In Switzerland, the SNB benefits from a high import ratio of over 50 % (in terms of gross domestic product), allowing it to use the strong Swiss franc to cushion price hikes for imported goods with monetary policy tools such as interest rate adjustments or currency interventions. The SNB will tolerate some appreciation of the Swiss franc, which is quite acceptable given the inflation differential in favour of Switzerland. However, the SNB has also signalled that it is still willing to counteract too strong an appreciation. This is not Interest Magic, but real monetary policy.

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Thomas Heller
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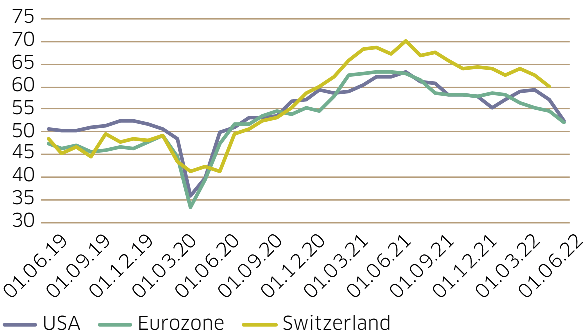
ECONOMY

There are currently two big questions: Which way is inflation about to go next? And, will there be a recession? Inflation is proving to be stronger and more persistent than anticipated. The scenario of a transitory inflation, which was still realistic at the beginning of the year, has become obsolete with the Ukraine war. The conflict has pushed up the inflation cycle by one to two percentage points and extended it. There is a threat of second-round effects that will keep the inflation level (significantly) above the central banks' target of 2 %. However, in the US, inflation may have peaked out or nearly so. On the one hand, commodity prices have hardly risen recently. On the other hand, weaker growth is slowing down the rise in prices. Moreover, base effects are beginning to curb upward pressure on prices.

We have been witnessing an economic slowdown for quite some time. The purchasing managers' indices are still lingering just above the growth threshold of 50 points (see chart). Yet, sentiment indicators (e.g. Ifo Index Germany, consumer confidence Eurozone) and leading indicators (e.g. Leading Indicator USA) have edged down lately. This decline in soft factors will be reflected in hard economic data. Stagflation – growth standstill with elevated inflation – is a realistic risk scenario. We do not currently expect a recession, i.e. an effective drop in economic output.

Purchasing managers' indices

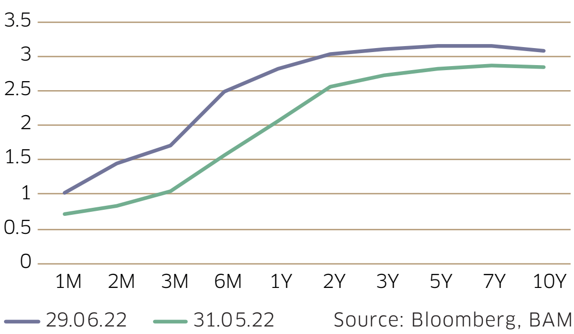


Source: Bloomberg, BAM

INTEREST

The US Fed recently raised the Fed fund rate by 75 basis points (for the first time since 1994), the SNB surprisingly raised interest rates in June even before the ECB, which will follow with a rate hike in July. The central banks are tightening interest rates quite sternly – and this is not the end yet. In the USA, further hikes of 75 basis points in July and 50 basis points each in September and early November are now priced in. In Switzerland, another increase to 0 % or even positive 0.25 % in September seems realistic. This would end the negative interest rate regime in Switzerland after almost eight years. Depending on how the Swiss economy and currency evolve in the second half of the year, another interest rate move might follow before the end of the year.

Yield curve US government bonds



Source: Bloomberg, BAM

Should the signs of a stronger slowdown in growth intensify over the coming weeks and months, central banks just might go a little easier on the monetary brake pedal.

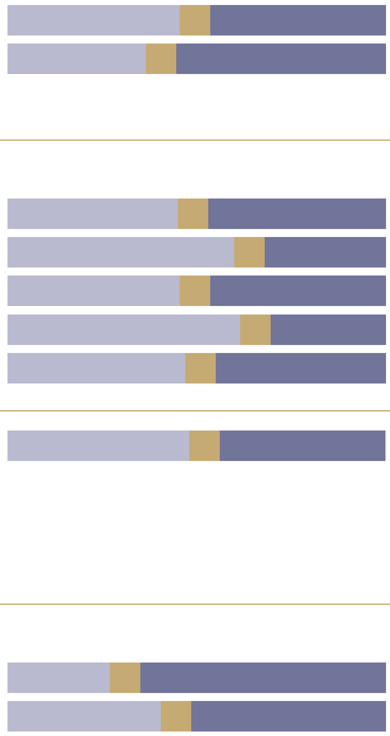
Rising inflation and the more restrictive monetary policy have pushed the entire yield curve upwards (see chart). The rise in interest rates led to a decline in bond prices, although these are mere book losses as the individual bonds are repaid at 100 %, unless there is default. 10-year Swiss bonds are now paying around 1 % again, the yield on 10-year US Treasuries is around 3 % – an improvement, even if modest. This could again attract a new investor here and there and soften a further rise in interest rates in the long run.

EQUITIES

Most stock markets clearly lost ground in the second quarter. Rising inflation, monetary tightening, lockdowns in China, supply chain issues and the Ukraine war all brewed into a veritable storm. At times, some indices were close to or below the -20% mark – the general threshold of a bear market. However, a bear market can not only be determined on the basis of an absolute number, but also on the duration of a downward trend – for instance, if markets keep declining over several quarters. In this sense, we are not experiencing a real bear market now that might be comparable to the financial crisis or the bursting of the tech bubble.

However, now the facts are on the table. Will inflation remain high for the time being? Yes! Are the central banks stemming the tide vigorously? Yes! Will there be a noticeable slowdown in growth? Yes! Market sentiment is still poor, but many of the negative developments have already been priced in. Of course, further setbacks cannot be ruled out and it is difficult to predict when the recovery will set in. Yet, from today's perspective, most of the correction should be behind us. Therefore, things might now begin to stabilise any day.

Asset class	Appraisal	Commentary
Bonds Government bonds Corporate bonds		Long-term interest rates have moved up considerably and may be close to, if not at, a peak. Further key interest rate increases to follow.
Equities Switzerland Eurozone United Kingdom USA Emerging markets		Market sentiment is poor, but many negative developments are already priced in. Further setbacks cannot be ruled out, but most of the correction is behind us.
Real Estate Switzerland		Real estate investments suffer from rising interest rates, but benefit from payout yields, which are still more attractive than those of bonds.
Commodities Oil Gold		Gold price is under pressure from rising interest rates and strong US dollar, but it benefits from its status as a safe haven asset.



unattractive – attractive   Current asset class assessment

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