BELVÉDÈRE
Asset Management

March 2023

THE SPIRITS THEY CALLED

MARKET INSIGHTS

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A central bank's key and in many cases sole objective is to ensure price stability. When it took up office in 1998, the European Central Bank (ECB) defined price stability as a rate of price increase below, but close to, 2%. The US Federal Reserve, too, is guided by an inflation rate of 2% – formerly defined as a benchmark, this became the official inflation target as of 2012. And it was basically a success story for many years. Between 2012 and 2020, the relevant core inflation in the US – which excludes volatile food and energy prices – was always between 1.2% and 2.4%, on average 1.9%. A precision landing! A similar picture emerges at a somewhat lower level for the euro zone. The range was between 0.2% and 1.7%, on average 1%. This is below the target of almost 2%, but in view of such a stable inflation trend, why would anyone complain that the ECB missed its inflation target most of the time?

The answer is: the ECB itself found a reason. In the aftermath of the financial and euro crisis, former ECB President Mario Draghi repeatedly conjured up the spectre of deflation. Deflation, i.e. a general, significant and sustained decline in price levels, is indeed not to be trifled with. It can bring about some severe consequences for an economy. However, the euro zone never came anywhere near deflation, and yet the ECB acted as if it had. With interest rate cuts, bond buying programmes and other measures that soon became part of many a central bank's standard repertoire under the term "unconventional monetary policy". This was also the case in the US, where Janet Yellen, then Fed Chair and now Secretary of the Treasury, commented on inflation as being too low – nota bene, when it stood at 1.7%.

This policy of adamantly preventing any crisis or recession, and the constant focus on raising inflation to the 2% target ultimately led to the former success story turning into its opposite. Monetary watchdogs responded to each ever so slight sneezle by injecting even more liquidity. Sometimes rightly so, for instance at the outbreak of the Corona crisis, but often needlessly – such as the 2019 interest rate cuts in the US – and more often than not quite generously.

The spirits they called are now here. Since the beginning of 2021, inflation has been soaring, abetted among other things by a dash of bad luck. With the pandemic, which initially had a dampening effect on prices but subsequently helped push them up, and with the Ukraine conflict, which fuelled inflation and extended the cycle. But the foundation for this was laid by the central banks with their liquidity glut in the years before. They are now laboriously struggling to put the genie back in the bottle – albeit, not exactly with any resounding success. Although inflation has been declining overall for some months, it will probably take until well into the next year before it hits the 2% target. The only way to speed up the process would be if central banks were to tighten their policy more significantly, even if accepting the possibility of a recession were the price. However, that does not (yet) look likely.

Th. Heller

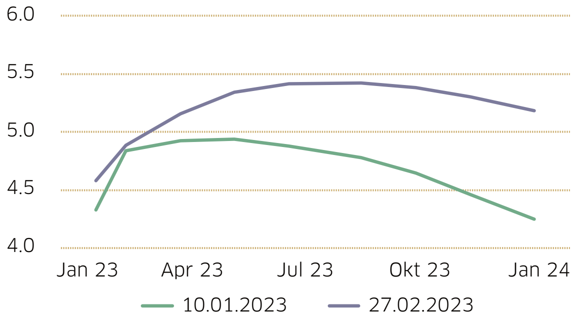
Thomas Heller
CIO, Belvédère Asset Management

INTEREST RATES

As expected, the ECB and the Fed raised their key interest rates at the beginning of February. However, interest in the monetary guardians' outlook and how their decisions were reached outstripped the interest rate steps as such. Accordingly, the minutes of the last Fed meeting, which were published last week, were eagerly awaited. In the end, they contained little that was surprising. The decision to raise the key interest rate by 25 basis points on 1st February was taken by a large majority. A minority, however, had voted for an increase of 50 basis points in view of the persistently high inflation. As far as the future key interest rate path in the US is concerned, three further interest rate steps of 25 basis points each until the summer are already priced in and so is a first cut at the beginning of 2024. Just a few weeks ago, the market had reckoned with fewer hikes and more significant cuts (see chart).

At the long end of the yield curve, there was a not entirely surprising countermovement after the marked decline in January. Due to fresh concerns about inflation, capital market yields have risen significantly across the entire yield curve. For the time being, we expect a consolidation at current levels. The next inflation figures and the central banks' interest rate decisions, which are due in mid-March, should bring some movement into the interest rate structure.

Key interest rate expectations US (in %)



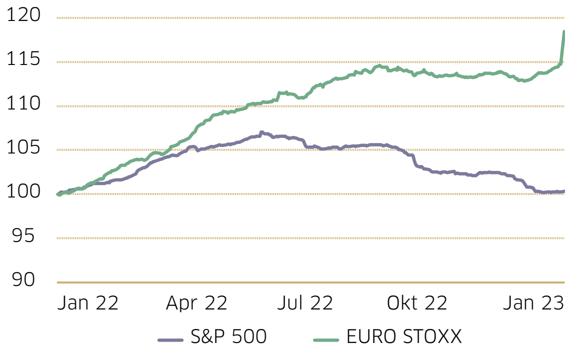
Source: Bloomberg, BAM

EQUITIES

Having been off to a strong start into the year, equity markets slowed to a more leisurely pace in February. Overall, euro zone markets performed better than the US. The month's events were dominated by the corporate reporting season. The figures reported by the defensive heavyweights in the SMI turned out to be less than impressive. In the US, fourth-quarter 2022 earnings dropped 4.8%, the first decline since the third quarter of 2020. In the euro zone, the overall picture was more encouraging, with earnings growth of 6.5%, although by this point only about half of the companies had released their reports. Based on the good figures from EU companies, earnings expectations were revised upward for the next 12 months, whereas in the US they were revised once again downwards (see chart).

Following the surprisingly upbeat performance since the beginning of the year, there are no triggers in sight that might help the rally go on. Notably in the US, we believe that much of the upside potential has already been priced in, such as a soft landing for the economy or a less restrictive monetary policy. Along with declining earnings estimates, the risk of a setback cannot be dismissed. We are more confident about the euro zone – the imminent economic recovery and lower valuations should bolster share prices.

Diverging earnings expectations trends
US vs. euro zone (indexed as of 01.01.2022 = 100)

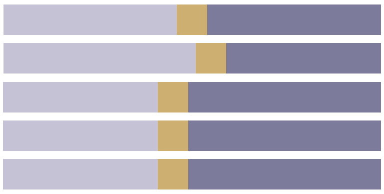


Source: Bloomberg, BAM

ECONOMY

In February, the economic outlook for the euro zone continued to brighten. Driven by tourism and financial services, purchasing managers in the services sector expect growth to pick up, while production and new orders are rising in manufacturing. Inflation was 8.6% in January, well below the peak of 10.6% last October. Falling gas prices suggest that this trend might continue. Against this background, it is hardly surprising that consumers are also feeling more optimistic about the future.

In the US, higher interest rates are leaving their skid marks on the real estate market. Existing home sales fell to their lowest level since October 2012, and banks have adopted tighter lending standards, which could have a negative impact on future corporate investments. Private consumption remains solid as a rock, surprising positively with a robust increase of 1.8% in January, driven by low unemployment as well as the remaining savings accumulated during the pandemic. However, the strong propensity to consume could mean that inflation will tail off less quickly than anticipated. Core inflation in personal consumption expenditure, which rose significantly sharper than expected in January, also points in this direction.

Asset class	Appraisal	Commentary
Bonds Government bonds Corporate bonds		The recent rise in capital market yields is now likely to be followed by a consolidation at current levels. Central banks will continue to raise key interest rates until the middle of the year.
Equities Switzerland Euro zone United Kingdom US Emerging markets		Many positive factors are already priced into current share prices, which makes equity markets prone to a setback. Unlike the US, in the euro zone, earnings expectations are brightening up.
Real Estate Switzerland		Valuations of real estate investments are still attractive by historical comparison. However, interest rate concerns are casting a gloom over any upward price moves.
Commodities Oil Gold		A stronger US dollar and higher interest rates are weighing on the gold price and there is little to suggest a significant recovery is imminent. The oil price could rise, if Russia lives up to its threats and cuts production.

unattractive ▬ attractive ■ Current asset class assessment

Imprint
 | Publisher: Belvédère Asset Management AG | Authors: Thomas Heller, Matthias Wullschleger | Stop Press: 28.2.2023

Belvédère Asset Management AG
info@belvedere-am.com | www.belvedere-am.com