BELVÉDÈRE
Asset Management

May 2023

DILEMMA

MARKET INSIGHTS

DILEMMA

The Corona pandemic has led to revenue shortfalls and additional public expenditure. In many countries – including Switzerland – governments were granting Covid 19-related payouts as a direct support for businesses and households. Large-scale spending programmes were initiated under high-minded names such as “American Rescue Plan”, “Build Back Better Plan” or “Next Generation EU”. All this has torn giant holes in the national budgets.

In 2020, the deficit of the 27 EU states had risen to 6.7% of gross domestic product (GDP), the highest level since aggregate figures have been available (1997). In the US, the 2020 deficit went as high as 15%, also a record. As a consequence, government debt rose significantly everywhere. In 2021 and 2022, the situation improved somewhat, though still at a high level. However, this decline had nothing to do with savings efforts – for government spending has continued to rise. What happened is that high inflation has inflated nominal GDP and thus reduced the burden of deficit and debt relative to this inflated GDP. Nevertheless, Italy, for example – Europe’s poorest performer in this respect – spent 4.4% of its GDP on interest payments again last year. And this figure is about to rise – more on this in a moment. It was right and important that governments intervened quickly to provide support during the Corona crisis. One might argue though about the extent – it was hardly too little. The consequences will be felt for many years to come and they will also pose a challenge to central banks.

What are the implications of higher debt amid rising interest rates? Countries with a large share of bonds close to maturity and with low coupons are affected more than others. They will need to borrow new money at higher interest rates. The US and Italy are among these countries. Both will have to refinance about one-third of their outstanding bonds in the next two years. If we take the current yield of 10-year government bonds as a reference, the Italian government will have to pay about twice as much in interest as before, the US one and a half times as much. Germany is in a much better position on this score. Only 16% of its outstanding bonds will mature by 2025 and these could be refinanced currently at only a slight premium. Switzerland’s situation is outright enviable by comparison. Based on today’s interest rate level, it could even borrow money now at more favourable terms than the bonds maturing up to 2025.

And how does all this affect central banks? Interest rates are currently under the influence of two opposed forces. On the one hand, there is higher demand for capital, which generates upward pressure on long-term interest rates. Moreover, given the high inflation, key interest rates would need to stay high or rise even more. On the other hand, hardly anyone can afford to pay (much) higher interest rates. This limits the scope of action for central banks, for – while they are primarily committed to price stability – they must also ensure the stability of the financial system and therefore cannot remain indifferent to the deteriorated debt situation. A veritable dilemma for monetary watchdogs.

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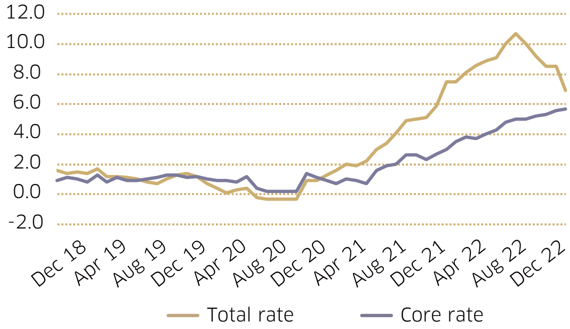
INTEREST RATES

During the month under review, interest rates in the US and the euro zone moved sideways on balance. In Switzerland, however, interest rates fell, which may be attributed to a flight to safe haven investments. However, after a brief increase due to the banking crisis in March, risk premiums (i.e. credit spreads) have decreased again and do not signal any stress to the system.

Inflation has receded both in the US and the euro zone to 5% and 6.9%, respectively. However, core rates, which exclude the volatile prices of food and energy, are holding up more stubbornly than expected (see chart). The main reasons for this are higher wages in the services sector, price increases in tourism and the persistently high housing costs in the US. Therefore, central banks may have little choice but to keep key interest rates high for longer and we are afraid that any hopes for cuts as from September, as those currently priced in by the US markets, are likely to find themselves disappointed.

We continue to anticipate a volatile sideways trend at the long end, without a sustained rise above the old highs of late 2022.

Euro zone inflation: core rate still on the rise (in % vs. prior year)



Source: Bloomberg, BAM

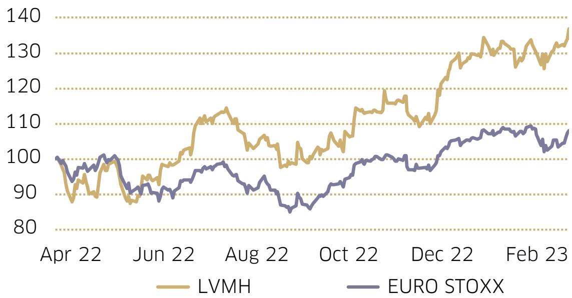
EQUITIES

Equity markets were able to recover fairly soon from the setbacks they experienced in March. This was mostly owed to lower interest rates at the long end, hopes for a less restrictive monetary regime in the US and bank bailouts. In April, the SPI (+3.6%) generally outperformed the Euro Stoxx and the S&P 500, both of which increased around 1.5%.

The first-quarter reporting season in the US reveals a general decline in earnings among S&P 500 companies. However, internet stocks – last year's losers – surprised on a positive note. For instance, Alphabet and Meta beat expectations with their reported results. In the euro zone, luxury goods stocks proved to be the drivers, led by LVMH, which was the first European stock to reach a market value of USD 500 billion (see chart). In Switzerland, the two pharmaceutical stocks Roche and Novartis were back in favour. Notably, Novartis saw its focus on attractive areas pay off and was able to report first-quarter revenues that were significantly above expectations.

Positive and negative factors roughly balance each other out when it comes to stock market outlook. Companies should certainly benefit from their recent cost reductions and investor sentiment is not euphoric, which is reflected in low equity exposures. On the other hand, valuations are fairly high, the risk of a recession has increased and investors' hopes for any imminent interest rate cuts in the US might be disappointed.

The glamour stock LVMH (indexed 28.4.2022 = 100)



Source: Bloomberg, BAM

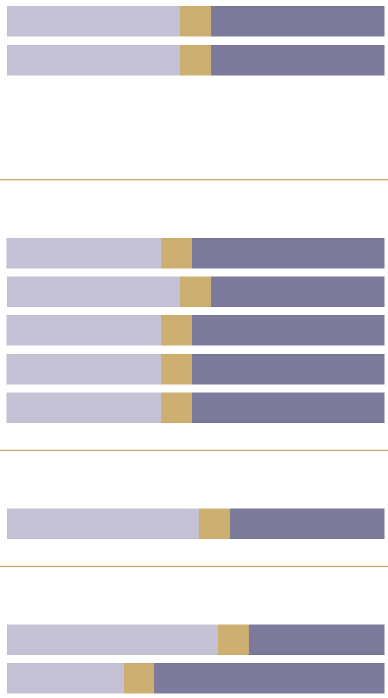
ECONOMY

In the first quarter, economic performance ranged from stagnation in the euro zone to slight growth in the US and accelerated growth in China. Concerns about a recession emerging in many parts, have so far failed to materialise. Opinions differ about the development going forward.

In their reporting, companies are not quite euphoric about their outlooks, but still cautiously optimistic. Many companies are benefiting from order backlogs, price increases or infrastructure programmes. The services sector (e.g. tourism) benefits from pent-up demand.

This contrasts with the macroeconomic leading indicators, including the inverse yield curve, which has always been a reliable harbinger of an imminent recession. Furthermore, the M1 money supply in the euro zone is shrinking and financing costs are rising. And then there is the banking crisis in the US. The segment of medium and small institutions is suffering an outflow of savings, which inevitably limits their lending activity. All these factors call for caution and are likely to weigh on the economy over the year. This need not necessarily lead to a recession, but the risks have definitely increased.

Asset class	Appraisal	Commentary
Bonds		Central banks will continue to raise key interest rates and we don't believe any interest rate cuts are likely this year. Long-term interest rates will probably hover around the current level.
Government bonds		
Corporate bonds		
Equities		After the surprisingly positive market performance so far this year, the air is getting thinner on the upside. Valuations are quite high and the market is currently pricing in too much interest rate fancy.
Switzerland		
Euro zone		
United Kingdom		
US		
Emerging markets		
Real Estate		By historical comparison, real estate investments are still quite attractive.
Switzerland		
Commodities		Gold benefited from the surge in uncertainty and should now consolidate. After the OPEC+ production cuts, the market is running into a supply deficit. Prices are likely to rise.
Oil		
Gold		



unattractive — attractive | Current asset class assessment

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