BELVÉDÈRE
Asset Management

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BETTER STRONG THAN WEAK

MARKET INSIGHTS

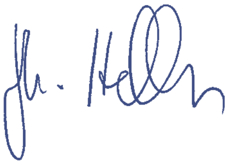
BETTER STRONG THAN WEAK

It is true that the Swiss franc has lost some of its value in recent weeks, especially against the US dollar. But it is still strong, very strong. This has to do, among other things, with the fact that since last year the Swiss National Bank (SNB) has deliberately strengthened the franc by selling foreign currency in order to fight inflation. Previously, the SNB had tried very hard over many years to make investments in the Swiss currency unattractive. A commentary by the SNB headlined "The role and extent of the SNB reserves" of February 2006 is therefore remarkable from today's perspective: "Thus, in the event of a Swiss franc weakness [...] the SNB can intervene in the foreign exchange market and support the franc by selling foreign currencies." The EUR/CHF rate was 1.55 at the time and rose to a high of 1.68 by autumn of 2007. The question at the time was whether the SNB should prop up the franc to prevent it from dropping too low. The situation today may not be the same as in 2006, but the question is the same: what is better for an economy – a strong currency or weak one?

If a currency depreciates by, say, 10%, products from that country become 10% cheaper on the world market, all other parameters remaining equal. Quite a competitive advantage. Just like that, without an effort, without (perceivable) costs. Achieving a price advantage of 10% via the real production processes would prove much more arduous. After all, this would require an increase in productivity, cost reductions and/or structural and fiscal adjustments in one's own country. This takes great efforts, time and entails (perceivable) costs (e.g. due to relocation of jobs). So what could be more obvious than to help domestic exports by weakening one's own currency?

This may be successful in the short term. However, devaluation cannot be a substitute for structural reforms, productivity gains and innovation in the long run. A weak currency makes one idle and sluggish, whereas a strong one keeps us on our toes. Therefore, productivity and innovation tend to be higher in countries with a strong currency. Accordingly, these countries are better positioned in global competition over a long term. And let's not forget: A strong domestic currency makes imported products cheaper and keeps inflation and interest rates low. This benefits everyone.

Governments and central banks are often trying to weaken their own currency for the sake of achieving a quick gain. However, this cannot work out for everyone. The way exchange rates work, every devaluation is matched by an appreciation (and every surplus in exports by a surplus in imports). Life with a hard currency may be challenging and sometimes strenuous. In particular, shock revaluations – as the ones Switzerland experienced in 2011 and 2015 – and devaluations tend to put an economy to the test. However, the long-term advantages of a strong currency clearly outweigh the disadvantages. Bottom line: It is better to have to deal with the problems of a currency that is too strong than one that is too weak.



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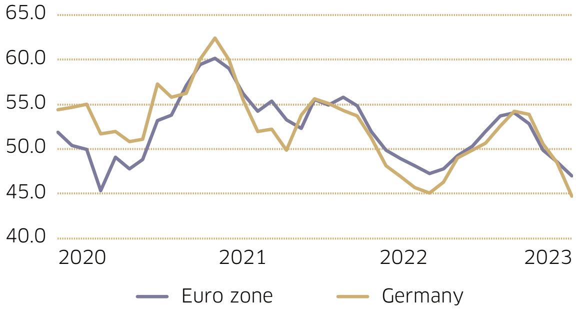
ECONOMY

As the global economy currently stands, on one side there is the US where economic performance has been underestimated for months. While economists were expecting a GDP growth of merely 0.5% for 2023 at the beginning of the year, estimates are now at 2%. On the other side, there are China and the euro zone. China is facing a persistent downturn in the real estate market, which is weighing down on growth and casting a gloom over consumer sentiment. The government has so far been rather hesitant about providing countermeasures and has thus failed to stop the downturn. In the euro zone, indicators such as the Purchasing Managers' Index are also pointing toward a weaker economy (see chart). Germany is particularly affected. Exports are declining, including those to China.

The outlook: It is safe to say that the risks for the next six months have increased. We do not expect any recessions, but we do reckon with stagnation in the euro zone. China is likely to grow well below potential. The duration of the downturn will depend largely on the extent of government interventions. However, even in the USA, the good times may not go on forever. Higher interest rates and a slowly weakening labour market are likely to cloud the outlook in the coming months.

Composite PMI Euro zone



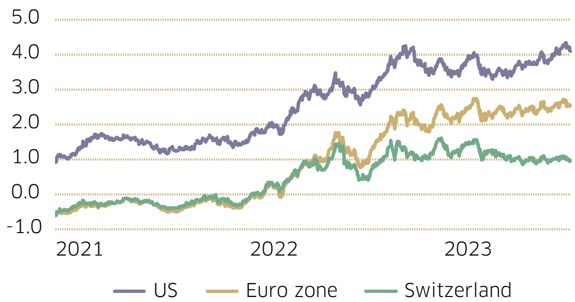
Source: Bloomberg, BAM

INTEREST RATES

In the global interest rate environment, three negative and thus yield-driving factors came together – the Fitch's credit rating downgrade for the US, the brisk government bond issuing activity there, and the Bank of Japan's further loosening of the yield curve control. The rise in interest rates was most distinct in the US, where yields on ten-year government bonds rose to 4.3%, the highest level since November 2007. Towards the end of the month, a drop in the number of job vacancies in the US was one of the factors that led to an easing in interest rates. We continue to believe that interest rates have peaked out and will come down slightly in the medium term. The main reason for this is the decline in inflation in the US. The latest data showed that housing is virtually the only area still driving inflation. Excluding this element, core inflation is only 2.5% and thus close to the US Federal Reserve's (Fed) target.

Among central banks, we expect another move each from the European Central Bank and the Swiss National Bank. In Switzerland, the monetary tightening is partly owed to the strong franc. The Fed is unlikely to raise its prime rate any further. Since interest rate hikes only have an effect on the economy with a lag of up to one year, it makes sense for the Fed to take a pause after the rate hike cycle of more than a year.

10-year government bond yields in %



Source: Bloomberg, BAM

EQUITIES

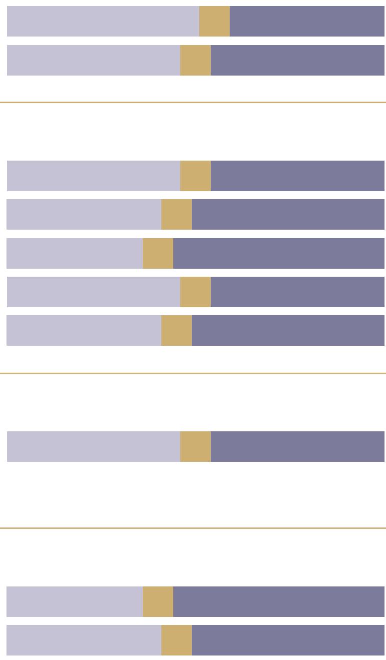
Having performed significantly better than expected in the course of the year to date, equity markets went in for a correction in August. The S&P 500 lost -1.6%, the Euro Stoxx -3.1% and the SPI -1.7%. The main reasons for the price losses were interest rate hikes in the US and economic concerns, notably in China.

Quarterly corporate earnings showed that a majority of companies in the US and the euro zone managed to exceed expectations. This was not the case in Switzerland, where the strong Swiss franc dampened results more than expected.

China and interest rates are the key drivers of the equity market performance ahead. European markets will see hardly any momentum at all before the downturn in China comes to an end. The other element would be interest rate cuts by the central banks. Although, such cuts are not yet in sight. On the positive side, earnings estimates are rising, especially in the USA.

In summary, the opportunities and risks are still more or less balanced. Therefore, we are likely to see a volatile sideways trend over the coming weeks.

Asset class	Appraisal	Commentary
Bonds		Interest rates have peaked. Slowing economic growth and declining inflation should lead to declining yields at the long end.
Government bonds		
Corporate bonds		
Equities		Economic fears and higher interest rates put a damper on August. In Switzerland, the strong currency is a burden. Higher prices would require an upswing in China and/or lower interest rates. Neither is imminent.
Switzerland		
Euro zone		
United Kingdom		
US		
Emerging markets		
Real Estate		Valuations remain attractive. However, at the same time, higher interest rates are weighing down on the real estate sector.
Switzerland		
Commodities		The rise in oil is running out of steam. Gold lacks triggers and investors continue to divest holdings.
Oil		
Gold		



unattractive — attractive ■ Current asset class assessment

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