Compass

4th Quarter 2023

AI euphoria displaces recession fears

Successful inflation policy of the SNB

Swiss real estate and bonds

Your wealth, our responsibility.

AI fantasies boost equity markets

Swiss equities struggled in 2023 due to the dominance of defensive heavyweights such as Nestlé, Novartis and Roche, while US mega-caps drove the market. Institutional investors' underweight in mega-caps relative to benchmark indices forced them to buy tech stocks, which in turn increased selling pressure on defensive sectors. Lower-than-expected inflation and interest costs, which are currently still manageable for companies, gave equities an additional boost. However, if high interest rates persist, issuing new debt is likely to become significantly more expensive.

In contrast to the euro zone and the US, inflation in Switzerland is well under control. Prudent monetary and fiscal policy protects against overstimulation. However, upcoming rent increases could have a negative impact on inflation. To mitigate this issue, the Swiss National Bank (SNB) can intervene with foreign exchange interventions as an alternative to interest rate hikes. Despite the criticism, the SNB maintains its credibility and thus controls inflation expectations in Switzerland.

The Swiss real estate market remains robust, with demand driven by immigration and demographic trends. Admittedly, real estate funds have suffered due to excessive premiums and rising interest rates. In the medium term, however, operating results should improve significantly again, which is why the current price slump offers buying opportunities.

The Fed's job is not done yet

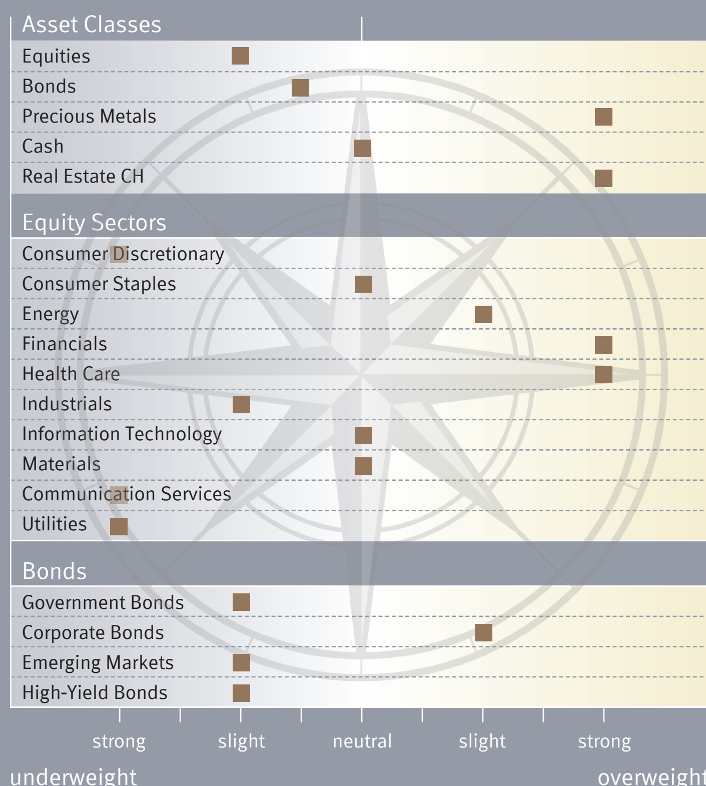
Lower-than-expected inflation figures and rather positive growth surprises have provided a strong tailwind for equity markets this year. The probability of a recession has also declined, but a soft landing is still unlikely to be enough to keep inflation under control, in our view. For this reason, we are maintaining our slight underweight in equities.

Since the beginning of the year, tech stocks in particular have benefited from the AI euphoria. In the last two months, however, there has been a sector rotation: the consumer staples, energy, financials and health care sectors have gained momentum, while the previous winners have weakened. The expected economic slowdown encourages us to maintain the current defensive positioning within equities.

Despite higher real interest rates, we maintain the tactical overweight in gold. In addition to the advantageous portfolio characteristics, the reasons are the ongoing geopolitical and rising macroeconomic uncertainties.

Our overweight in Swiss real estate remains unchanged. Real estate funds in particular have corrected sharply since the start of the interest rate hike cycle and are now trading at significant discounts to their net asset values in some cases.

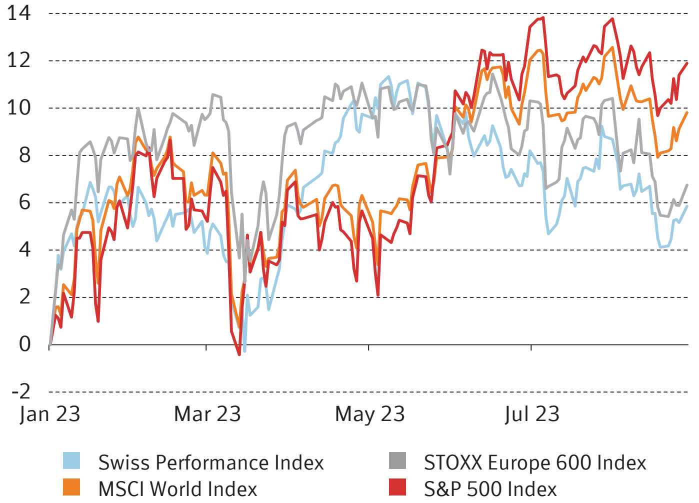
Asset allocation recommendation as of October 1st, 2023 for investors with CHF as their reference currency.



Current Topic:
AI euphoria displaces recession fears

Current Topic 1:

Year-to-date performance in CHF (percent)



AI euphoria leaves the SPI behind

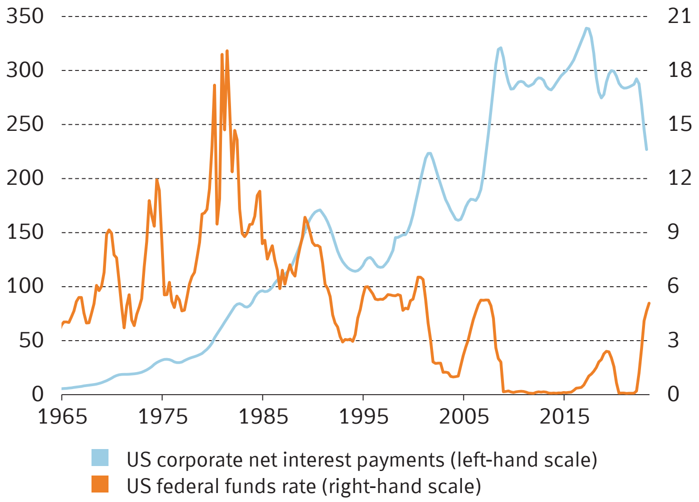
Swiss equities have performed poorly since the beginning of the year. Caused by the dominance of Nestlé, Novartis and Roche, the SPI has an extremely defensive character, with a sector weighting of 35% in healthcare and 21% in consumer staples. These sectors struggled in the current AI euphoria, in which primarily US mega-caps from the IT sector were in demand. Their outperformance was amplified by the fact that institutional investors were underweighted due to the high weighting of mega-caps in the benchmark indices. When share prices perform as they have this year, this underweight increases. In order to limit deviations from their benchmarks, investors were forced to buy, which in turn led to selling pressure in defensive sectors.

Current Topic 2:

Source: FRED

USD billions

Percent

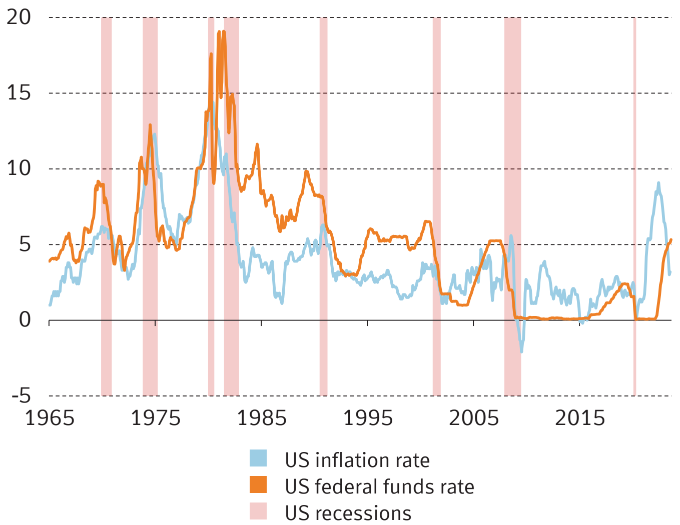


Debt could soon become more expensive

However, the rally in the stock markets cannot be explained by AI fantasies alone. Unexpectedly low inflation figures and decent economic growth provided a boost. In addition, consumer prices rose faster than nominal wages until spring, which meant higher profit margins for companies. Paradoxically, interest rate hikes were also profitable, as many companies had used the period of low interest rates during the pandemic to extend their debt maturity. Now they are making profits again on cash holdings, while interest costs on the liability side are rising only slowly. However, if the high-interest rates phase is prolonged, the downward trend in interest costs is likely to reverse quickly, as companies would have to roll over expiring low-interest bonds at higher rates.

Current Topic 3:

Percent



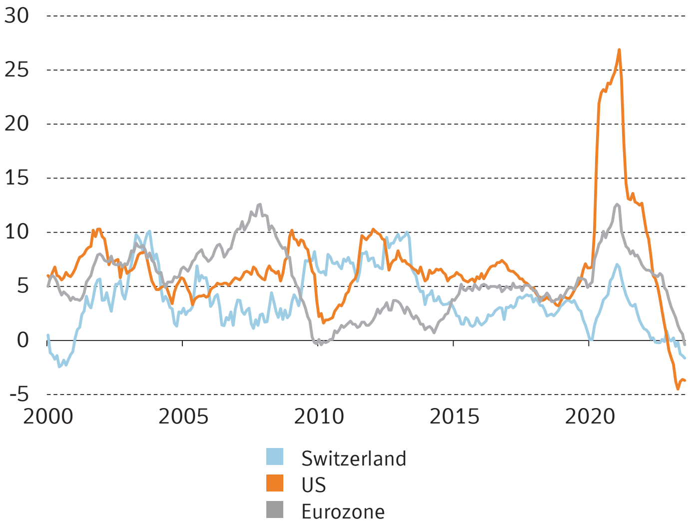
Investors expect a soft landing

This makes the optimism of equity analysts all the more surprising: they expect global equity market earnings to grow by 8.5% next year and by as much as 11.5% thereafter. Even if these optimistic expectations materialise, equities are currently already very highly valued according to our models. At the same time, bond investors expect the Fed to cut interest rates by more than 0.75% and the ECB by 0.25% by the end of 2024. The markets are therefore expecting an almost perfect soft landing. In such a scenario, the global economy does not fall into a severe recession, but cools down just enough for inflation to normalise. The monetary policy reins could thus be loosened again next year. Historically, however, the monetary authorities have never managed such a feat from high inflation levels as in this cycle, as the Fed's rather poor track record shows.

Basic Trend: Successful inflation policy of the SNB

Basic Trend 1:

Annual money supply growth in percent



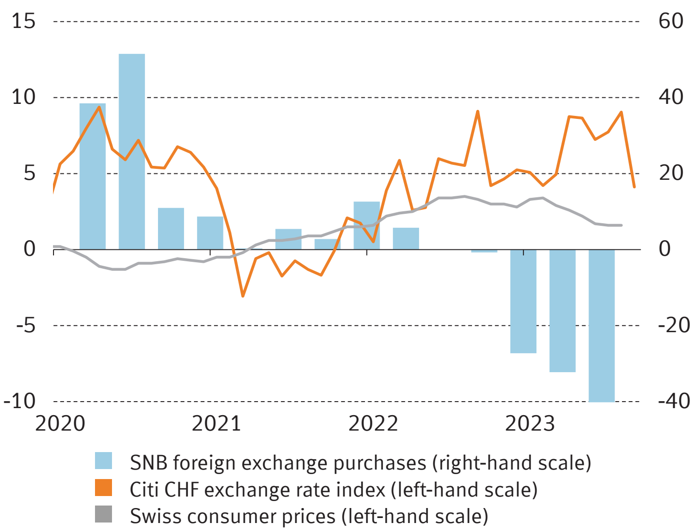
An island of price stability

In contrast to the euro zone and the USA, inflation in Switzerland is well under control. The attractiveness of the business location ensures a steady influx of workers from neighboring countries, which keeps the labor market competitive and dampens wage growth. Moreover, thanks to prudent monetary and fiscal policies during the pandemic and the energy crisis, Switzerland is now less likely to have to contend with the consequences of overstimulation. However, the latest inflation figures of just 1.5% are somewhat misleading. They do not yet include the upcoming rent increases as a result of the first increase in the mortgage reference rate, which is calculated from a basket of outstanding mortgages and therefore reacts only very sluggishly.

Basic Trend 2:

Source: SNB

Percentage change YoY



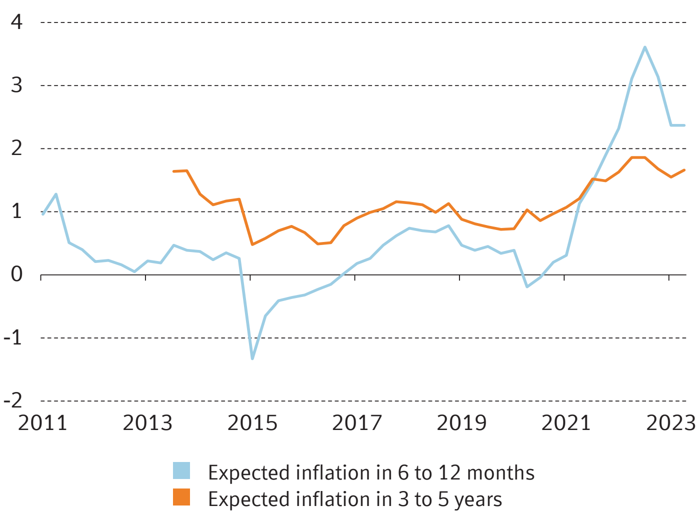
Effective foreign exchange market interventions

Linking rents to interest rates complicates the monetary policy of the Swiss National Bank (SNB) as the restrictive interest rate policy also has an unintended inflationary effect with a time lag. Although rents account for only 19% of the CPI basket of goods, they disproportionately affect the lower income brackets. In order to avoid excessive rent inflation, the SNB is likely to continue to rely on foreign exchange intervention as its preferred monetary policy tool. While the SNB had still bought foreign currencies on a massive scale during the pandemic in order to weaken the Swiss franc, it did a complete turnaround from mid-2022. Thus, hardly any inflation was imported. If inflation in the euro zone does not normalize, the SNB will have enough ammunition to further support the franc.

Basic Trend 3:

Source: SNB

Swiss inflation expectations in percent



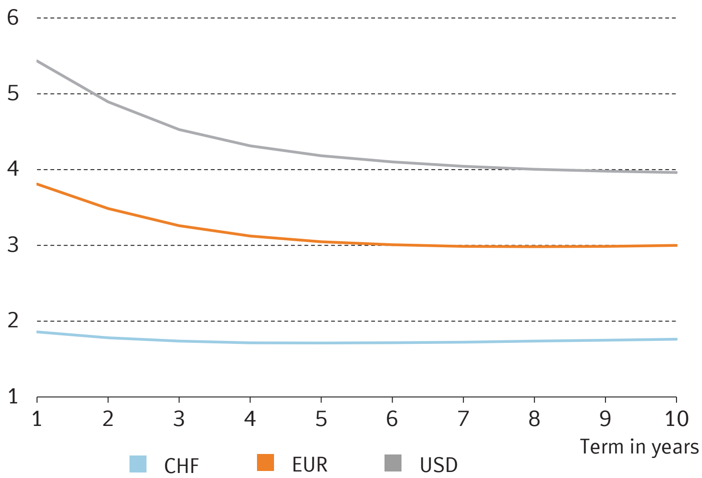
Controlled inflation expectations

Even though the SNB has been criticised for its losses on foreign exchange reserves, overall it has done a respectable job, not only in terms of realised inflation. Moreover, thanks to its high credibility, inflation expectations are well under control. Although there are no inflation-linked bonds denominated in Swiss francs from which market expectations for inflation can be derived, the SNB does publish the results of company surveys in its Quarterly Bulletin. These show that medium-term inflation expectations have never risen above 2%. Only short-term inflation expectations briefly got out of hand at the beginning of the year, but have since quickly returned to normal.

Knowledge & Experience: Swiss real estate and bonds

Knowledge & Experience 1:

Swap interest rate in percent

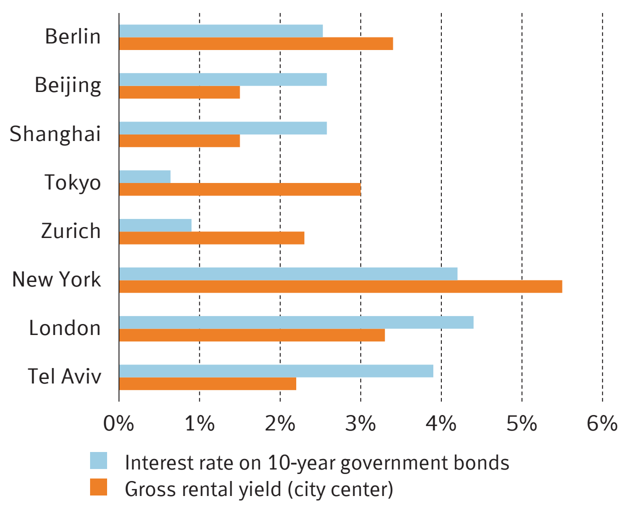


Opportunities in the Swiss bond market

With inflation expectations firmly anchored and interest rates rising, the chances of positive real returns on CHF bonds in the future are good. Although the interest rate level appears modest by international standards, we see investment opportunities again, especially in first-class corporate bonds. If inflation does not ease, the SNB has an alternative tool at its disposal thanks to its foreign exchange reserves and does not have to rely solely on interest rate hikes. Moreover, the yield curve is not inverted, which makes bonds with longer maturities attractive. Bonds issued with low coupons during the low interest rate phase are particularly interesting for Swiss investors. Their yield to maturity is mainly attributable to tax-exempt capital gains.

Knowledge & Experience 2:

Source: numbeo.com



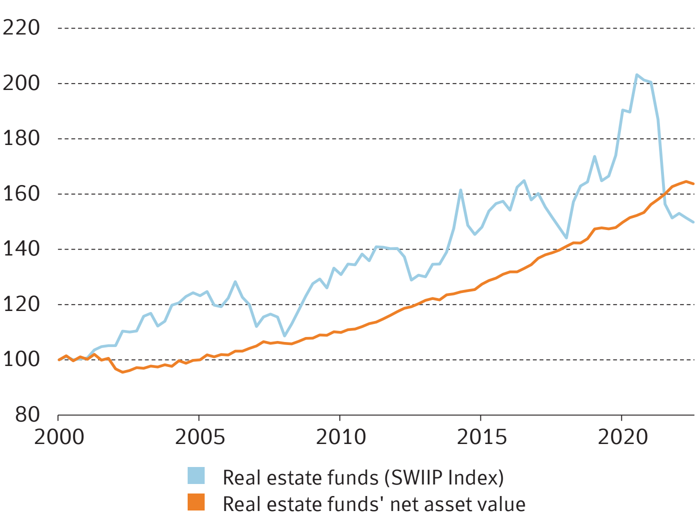
Robust real estate primary market

Once again, the Swiss real estate market is proving to be robust in turbulent times. Immigration, restrictions on the densification of residential space, and demographic trends are ensuring constant excess demand, especially in city centers and agglomerations. Despite a long period of negative interest rates, price excesses have remained limited. First, restrictive financing regulations for residential property provide stability. Second, investors (private individuals, pension funds, insurance companies, real estate companies) always conduct transactions with a view to returns rather than speculation. Since rents are affordable in relation to average household income, there is sufficient scope to pass on increases in interest rates and inflation.

Knowledge & Experience 3:

Source: SFP Group

Indexed performance in CHF



Real estate funds are priced favorably

The performance of real estate funds was less favorable. In the absence of alternatives, negative interest rates led to excessive premiums on net asset values. Since the beginning of 2022, prices have fallen by 17% and some funds are now trading at significant discounts. Funds with high variable debt were particularly sold off, as the rise in interest rates is directly reflected in costs. While commercial rents are quickly adjusted to inflation, the first rent increase for around half of all residential properties will not take place until October. As the mortgage reference rate rises, broader increases will follow next year. This should improve operating results in the medium term. Despite higher debt, real estate stocks held up better. This was due to index heavyweights such as SPS and PSP, which were sought after as safe havens by European real estate investors.

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