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CIO Viewpoint

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Flying blind on the financial markets

No sooner do people slowly return to normality after two years with Corona than Europe and the whole world are confronted with the terrible war in Ukraine. At present, it is difficult to predict when and under what conditions peace will be achieved.

In addition to the great human suffering caused by this war, the economic consequences are also drastic, both in the short and long term. The Russian and Ukrainian economies account for only 3% to 4% of the global gross national product. However, Russia is one of the largest suppliers of oil and gas and also an extremely important supplier of important raw materials such as, in particular, industrial metals (palladium, nickel, copper) and potash salt (40% of the world market), which is processed in large quantities into mineral fertiliser. In addition, Russia and Ukraine are among the most important wheat exporters in the world, with a share of around 25%, and play a central role in Africa's food supply in particular. The war in Ukraine has further catapulted gas and also oil prices, which had already risen sharply due to the Covid distortions. The same applies to numerous important metals, such as nickel, whose price shot up by almost 150% at its peak after the war began. In addition, because of the war, the expected normalisation of the severely disrupted global supply chains is taking longer than hoped. Important intermediate products are also in short supply because of China, which continues to adhere to its strict COVID policy with hard lockdowns and the temporary shutdown of entire cities and industrial regions. No wonder inflation rates are spiralling upwards and we are confronted with new price shocks almost daily.

Against this backdrop, it is actually astonishing how well the stock markets have weathered the nasty environment and have largely made up for the losses after the outbreak of war in Ukraine. Bond prices, on the other hand, took a bigger hit, with the 10-year US Government Bond Index, for example, losing almost 9% in the first quarter. The sharp rise in bond yields was fuelled in particular by the U-turn by the US Federal Reserve, which for too long assumed that inflation was temporary. With headline inflation (including energy and food) recently at 7.9%, it is hardly surprising that Fed officials are now adopting a very different

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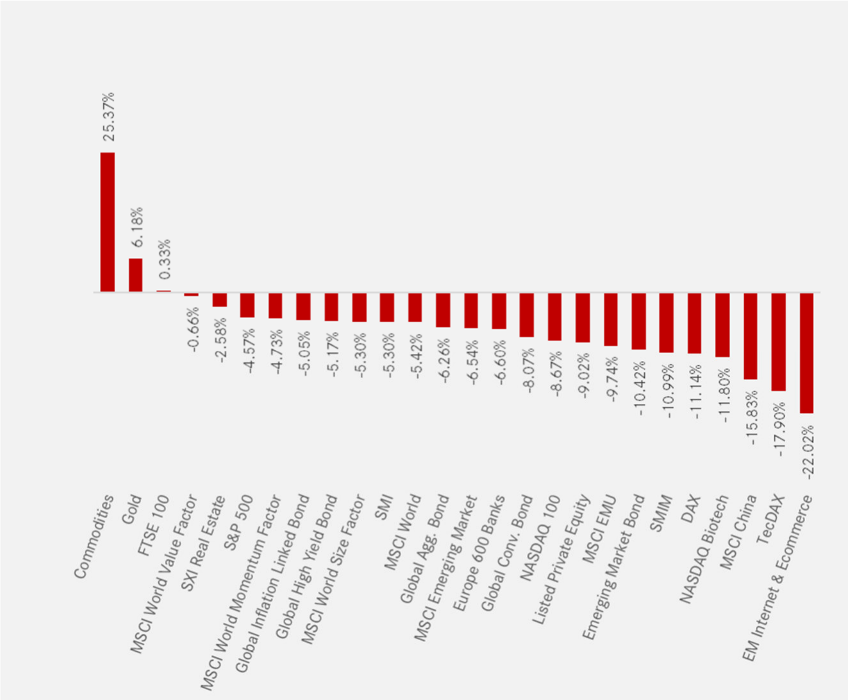
tone regarding future monetary policy. The majority of important market participants, such as the major US securities houses, now expect at least six more interest rate hikes of 0.25 percentage points this year and an increase in Fed rates to 3% or more next year. In Europe, the money markets imply four interest rate hikes of 0.25 percentage points each for the next 12 months.

Chart: Select ETF Performance Q1 2022



Source: Bloomberg 5 April 2022

The FED between Scylla and Charybdis

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Of course, the Fed is not under the illusion that higher interest rates will push prices at the pump down. In view of a 5% increase in wage costs compared to the previous year, the central bankers are much more concerned about a wage-price spiral. The central bankers are certainly not to be envied in their task: Disrupted supply chains, booming commodity prices, a tight labour market and possible inflation-promoting structural changes such as the emerging economic bloc quickly turn inflation forecasts into wastepaper. The tough stance now adopted by the Fed should certainly also help to steer the inflation expectations of producers and consumers in a more orderly direction. How far the Fed must and can go in this interest rate cycle to successfully fight inflation is, however, uncertain in this blind flight of monetary policy. If the Fed wants to get inflation under control, this may only be possible at the price of a recession next year or the year after. The development of the USD yield curve is interesting in this respect. The yields of 2-year and 10-year Treasury bonds are now almost at the same level and the yield curve could soon become inverted, which in the past was often a harbinger of an economic recession.

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Economic skid marks in Europe

The latest labour market data from the USA point to an economy that continues to perform well, also benefiting from consumers' pent-up demand after 2 years with Corona. However, the massively higher commodity prices also reduce consumers' purchasing power. The post-Corona economic boom is therefore likely to lose momentum in 2023 and 2024. The economic outlook in Europe is more gloomy than in the USA. Unlike in the US, consumer confidence has plummeted (ZEW index fell from +48.6 to -38.7 within one month!) and wage settlements have so far been well below inflation rates, weakening purchasing power. In addition, the massive energy price increases are extremely painful for many branches of industry, whereby the high dependence of German industry on Russian gas imports can hardly be sustainably reduced from one day to the next. The envisaged accelerated expansion of "green energies" is rather a generational project with huge investment needs. For once, little can be expected from China as a global economic pillar. Rigorous lockdowns in important industrial regions when the Corona numbers sprout up, as recently in Shanghai, are associated with an enormously high economic toll. The economic braking effects in China are also exacerbated by the persistently high overcapacities in the real estate market, which will need to be re-dimensioned in the coming years. Doubts are growing that China will be able to achieve its self-imposed economic growth target of 5.5% in 2022.

Table: Consensus Forecasts

	GDP growth real (in %)			Inflation CPI (% Chg YoY)		
	2022	2023	2024	2022	2023	2024
US	3.4	2.3	2.1	6.2	2.6	2.2
China	5	5.2	5	2.2	2.3	2.1
India	8.9	7.7	6.4	5.4	5.5	4.8
Eurozone	3.4	2.5	1.9	5.5	2.4	2
Japan	2.3	1.7	1	1.3	0.8	0.9
UK	3.9	1.8	1.6	8.4	4.6	3.2

Source: Bloomberg 5 April 2022

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Tight markets for inflation-indexed bonds

Caution seems to be warranted on the bond markets in view of the interest rate steps expected in the USA as well as in Europe. This is especially true for long maturities, as yields on 30-year bonds in the USA are surprisingly slightly below those on 5-year bonds. Accordingly, the risk on long-dated bonds is currently quite unfavourable in relation to the potential return, especially if inflation proves to be more persistent. Since many investors are looking for a hedge against inflation, inflation-indexed bonds are quite expensive. It should be noted that this segment of the market is quite narrow in relation to the total bond volume and thus also susceptible to corrections if positive surprises on the inflation front should emerge again for once. High-yield bonds and emerging markets bonds are still among our favourites in the fixed income segment. For example, high-yield bonds in the energy sector are still interesting.

Uncertainties call for a little more caution in equities

" For various reasons, we nevertheless believe that a little more caution is in order and we are reducing the weighting of equities to neutral. "

The securities firm Goldman Sachs recently pointed out in an analysis that over the last six cycles of rising interest rates, the equity markets, as measured by the S&P500 index, have achieved an average annualised performance of around 9.5%. Interest rate hikes, therefore, need not be bad for equity markets, especially if they are accompanied by a strong economy. Numerous empirical studies indicate that equity investors do not base their expectations primarily on the development of money market rates, but rather on long-term yields, which have not corrected that much so far. For various reasons, we nevertheless believe that a little more caution is in order and we are reducing the weighting of equities to neutral.

After several decades of a tendentially deflationary economy, the marked inflationary push triggered mainly by the COVID crisis may be a kind of paradigm shift with structurally higher inflation rates. So far, equity analysts have not sharply lowered earnings expectations for the current year (+ 9.6% for the US and 8.2% for Europe), although against the backdrop of a weakening economy, higher input prices and wage increases will noticeably reduce margins at many companies. In principle, interest rate hikes make growth companies more expensive, as their profits are very much in the future. Nevertheless, we maintain a mix of attractive technology stocks and stocks of companies with high dividends and some market power.

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After the sell-off of numerous second-tier technology stocks in recent months, such "fallen angels" may well be worth a look. Shares in commodity companies or investments in commodities, which can be invested in via ETFs or ETPs, for example, also remain interesting. However, investors seeking investment protection with investments in commodities should note that this asset class was already able to achieve significantly higher prices in the first quarter of 2022 and can be susceptible to (temporary?) setbacks. For example, it cannot be ruled out that the oil price could fall well below USD 100 per barrel again if individual OPEC countries open their floodgates more or even if more crude oil from countries such as Iraq, Venezuela and Iran comes onto the markets again.

If investments in commodities are to be made, then shares in companies that profit from the long-term transformation towards a "green economy" with renewable energies should not be forgotten.

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