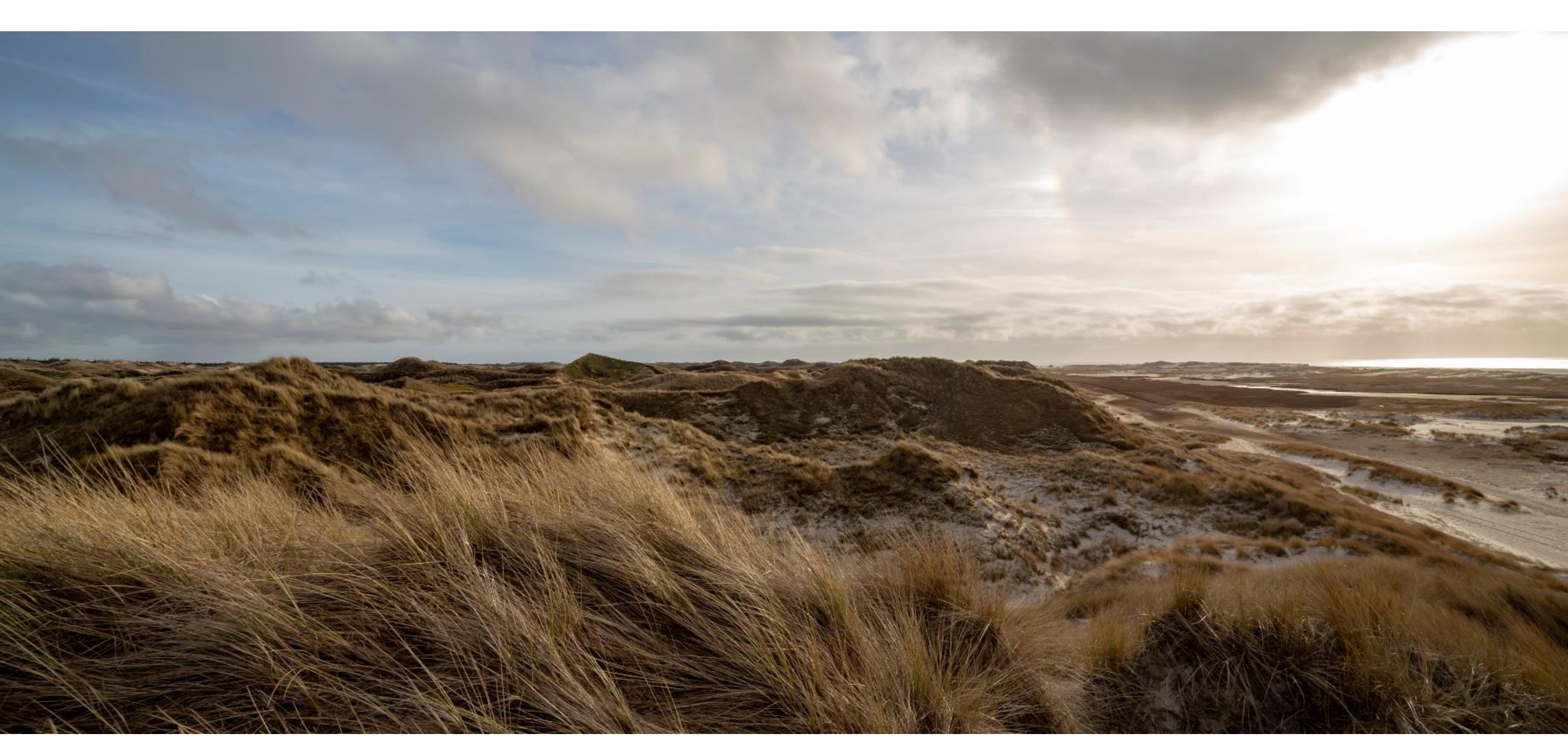
Market Outlook Fourth Quarter 2022

The consequences of rising interest rates



Market Outlook Fourth Quarter 2022

The consequences of rising rates

Global Economy

- Stubbornly high inflation is forcing central banks to raise their policy rates further.
- The risks of recession are rising.

Financial markets

- We expect a volatile market environment with rising interest rates and declining equity markets.
- Higher interest rates reduce the relative attractiveness of equities and real estate funds. At the same time, refinancing costs for companies are rising.

Risks

- Tightening of monetary policy across the global could push the world economy into recession.
- China's zero-covid policy is not only putting a strain on the production capacities of the second largest economy, but also on global supply chains, delaying the decline in inflation.
- Significant geopolitical risks remain. A further escalation of the war in Ukraine would be highly inflationary and cutting off growth.

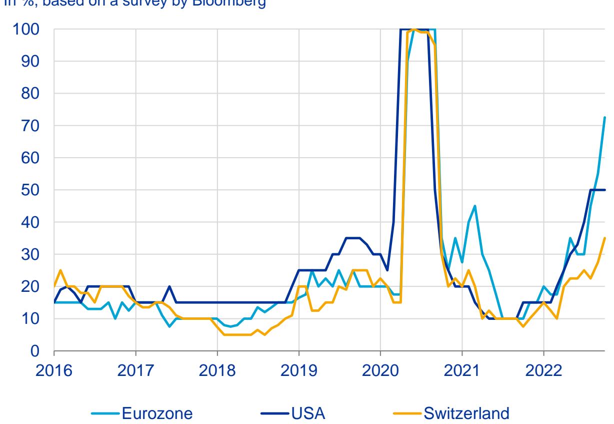
World economy: Recession signals

Economic risks have intensified in the last quarter. The rising cost of living, falling real income, tighter financing conditions and an energy crisis in Europe are clouding the economic growth outlook.

Chartic 1

Probability of recession in the next twelve months

In %, based on a survey by Bloomberg



Source: Baloise Asset Management, Bloomberg Finance L.P. , as of 05.10.2022

Leading economic indicators such as the purchasing managers' indices (PMI) point to a weakening of economic momentum across the board. The sharp decline in new business orders and the gloomy business outlook suggest that the downturn, especially in Europe, will accelerate further in the coming months.

A Bloomberg survey shows that analysts rate the likelihood of a eurozone recession in the next 12 months at over 70% (Chart 1).

While economic growth is falling, inflation remains stubbornly high. The development in the coming months is strongly dependent on energy and food prices. This in turn depends on the geopolitical situation in Europe. We do not expect any peaceful end to the conflict. An escalation could push commodity prices and thus inflation even higher.

Switzerland: Not immune to slowdown abroad. Many economic indicators point to a slowdown. For example, the KOF economic barometer has been below the 100-point mark for the past five months, signalling below-average growth for the Swiss economy. Consumer sentiment also deteriorated in the wake of the rise in inflation. The SECO survey shows that the population was even more pessimistic in July than at the height of the pandemic. This is likely to weigh on consumption in the coming quarters, which is currently still supported by the positive labour market situation. The seasonally adjusted unemployment rate was 2.1% in September, a 21-year low.

In September, inflation was 3.3% and thus above the target range of the Swiss National Bank (SNB). A major driver is the price increase of imported goods, which were most recently 7.8% more expensive than in the previous year, but inflation of domestic products is also picking up. However, we expect inflation to be close to

its peak, but not getting close to the 2% mark again until next year.

USA: Inflation as a key issue for the upcoming elections. The rising cost of living is at the centre of political debates. Because even though wage growth is above average at 5.7%, it is below general inflation. This means that Americans' real income has been steadily declining since spring 2021. In August, inflation-adjusted wages shrank by 3.4% year-on-year. Not surprisingly, consumer sentiment hit a record low at the half-year point. Recently, sentiment has brightened somewhat thanks to somewhat lower oil and petrol prices, but surveys continue to point to little confidence. Business optimism is also modest. The ISM PMIs for manufacturing and services have been on a downward trajectory since last autumn.

The Fed's preferred inflation measure, the personal consumption expenditure deflator, is 6.2%. Excluding food and energy prices, inflation has been declining since February and currently stands at 4.9%. We believe that the peaks of inflation are behind us. But even at the end of the year, inflation should still be significantly above the Fed's long-term target of 2% on average.

Eurozone: Energy crisis likely to trigger recession. The EU set itself the goal of having at least 80% of its gas reserves filled by November. At the end of September, the storage facilities were 88% full. That is enough for 95 days of consumption on average. Nevertheless, households and industry are suffering from the massive price increase and possible consumption cuts. The risk is particularly great for Germany's industry. In 2019, Germany accounted for around a quarter of the total natural gas consumed by EU manufacturing. An additional damper on Germany's economy comes from a weaker China, as China is Germany's main trading partner outside the EU.

The economic weakness is already visible. Not only did the Eurozone PMI fall for the third month in a row in September, the decline was actually the largest since 2013, with the exception of the months during the lockdowns. The survey results, coupled with the risks around energy supplies, suggest that economic momentum will weaken even further in the winter. A recession is becoming increasingly likely.

Inflation reached an all-time high of 10% in September. With a year-on-year increase of 40.8%, the energy component of the inflation basket is providing the strongest upward pressure. But core inflation is also firming. It rose from 4.1% in August to 4.8% in September.

China: Zero-covid policy slows consumption. Sporadic lockdowns in several cities due to Corona outbreaks are dampening domestic consumption and causing high uncertainty among the population. Consumer sentiment has remained at record lows since March. The manufacturing PMI also fell to 48.1 points in September, signalling a slowdown in growth. The government is pursuing slightly expansionary economic policy, but not nearly enough to reach its economic growth target of 5.5% if the zero-covid policy is maintained and the real estate sector remains in crisis. Analysts currently therefore expect a growth rate of 3.3% for this year.

The rather sluggish economic development also influences inflation. Thus, unlike in many other regions, inflation of 2.5% is below the Chinese central bank's inflation target of 3%. The rate for producer prices, which was still over 10% at the end of 2021, has also fallen significantly in recent months and was only 2.3% in August.

Figures at a glance, in percent compared to previous year

		2021	2022	2023
Switzerland	GDP growth	3,8%	2,2 %	0,9 %
	Inflation*	1,5%	3,3 %	1,4 %
USA	GDP growth	5,7%	1,6 %	0,7 %
	Inflation**	5,3%	5,4 %	2,4 %
Eurozone	GDP growth	5,2%	3,0 %	0,2 %
	Inflation*	5,0%	9,5 %	3,1 %
China	GDP growth	8,1%	3,3 %	5,0 %
	Inflation*	1,5%	2,7 %	2,0 %

* Year-end value. ** Measured as the PCE deflator.
Source : Baloise Asset Management, Bloomberg Finance L.P. ; 05.10.2022

Monetary policy: A new era for Europe's interest rate policy

Since the Jackson Hole meeting in August this year, it has been clear that central banks see fighting inflation as a priority, even if it means a significant decline in economic growth and an increase in the unemployment rate. After all, if inflation is not tamed soon, the consequences for the economy are likely to be even more negative in the long run. Thus, the Danish and Swiss National Banks also ended their negative interest rate policies in September and ushered in an era for Europe's monetary policy.

In the fourth quarter, policy rates are therefore likely to be raised again significantly. Investors are currently assuming that the rise in interest rates will be strongest in the Anglo-Saxon regions (see chart 2).

The **Fed** raised its policy rate by 75 basis points in each of the three last months. At the end of September, the target range for the policy rate was accordingly 3.00 - 3.25%. In view of the still high inflation, the Fed is signalling a rate of 4.38% for the end of the year, just under one percentage point higher than what its dot plot suggested in June. The interest rate forecasts for the coming year were also revised upwards.

To normalise monetary policy even faster, the Fed also accelerated the reduction of its USD 8.8 trillion balance

sheet in September. This is now being reduced by USD 95 billion per month.

Chart 2
Source: Baloise Asset Management, Bloomberg Finance L.P. , as of 05.10.2022

Even the otherwise rather dovish **ECB** raised interest rates by 75 basis points in September and announced further increases for the next meetings. With an interest rate for the deposit facility of 0.75%, interest rates in the euro area remain very low and stimulating for the economy. Therefore, according to ECB chief Christine Lagarde, policy rates should be raised quickly so that they at least reach a level that no longer stimulates economic growth. Market participants assume that interest rates could rise by another 120 basis points by the end of the year.

Despite an inflation rate of 3.3%, which is subdued by international standards, the **Swiss National Bank** (SNB) is acting decisively. In September, it ended its negative interest rate policy after almost eight years and raised the key interest rate by 75 basis points to 0.5%. This is intended to counteract the spread to goods and services that have so far been less affected by inflation. The SNB is also prepared to sell foreign currency if necessary.

Bonds: Significantly higher refinancing costs

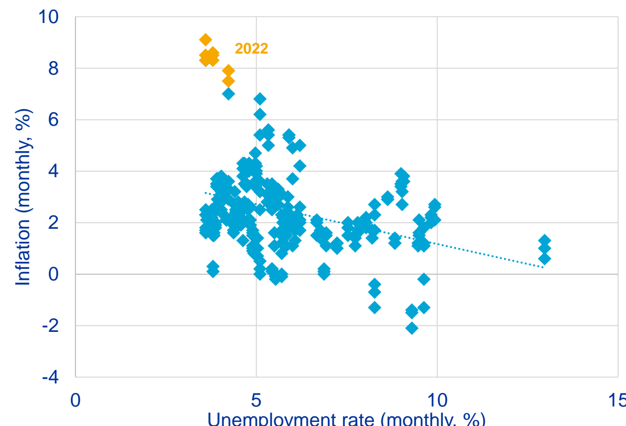
Review: The third quarter of this year was challenging for corporate bond investors. The war in Ukraine continues to spur volatility and an early settlement of the war seems increasingly unlikely in view of the latest developments. The partial mobilisation of Russian soldiers sent a clear signal in this context. At the same time, the central banks continued to face a high level of inflation and acted accordingly (see section "Monetary policy").

There was high market volatility in Europe after the UK Chancellor of the Exchequer, Kwasi Kwarteng, unveiled far-reaching tax reform. The package included tax cuts of up to £45 billion to be financed by additional government debt. As a result, the yield on 30-year government bonds shot up by almost 100 basis points (bp), forcing the Bank of England to intervene in the market.

Credit spreads tightened surprisingly sharply in early July but are now pricing in the high uncertainty again. The credit spreads of the Bloomberg Global-Aggregate Corporate Index are now back at 180 bp, the highest level since the outbreak of the corona pandemic in March 2020. The spread between the BBB and BB rating segments also widened significantly again recently and, at around 235 bp, is almost twice as high as at the beginning of the year (January 2022: 130 bp).

Chart 3

Phillips curve: USA 2000 to September 2022



Sources: Baloise Asset Management, Bloomberg Finance L.P., as of 05.10.2022

Outlook: Central banks will continue to do everything in their power to fight inflation in the medium term, i.e., further interest rate hikes will be inevitable for both the Fed and the ECB. Whether they will do so as vehemently as in recent months remains to be seen.

The ECB expects an inflation rate of 5.5% in 2023 and a return to a level close to 2% only in the following year. The real purchasing power of households is decreasing, which is why companies in cyclical sectors in particular are already reporting declining demand and resulting high inventories. In many countries, households are to be supported as much as possible, especially regarding energy costs. Depending on the form of the expansive fiscal policy, however, this can have an inflationary effect and cause government debt to soar (example: UK).

A potential conflict between fiscal and monetary policy could force central banks to raise key interest rates substantially in the coming months as well.

In the medium term, the higher interest rates will dampen economic growth and very likely cause a recession, which will, for example, break the inflationary wage-price spiral (higher unemployment) and effectively fight inflation (see chart 3).

Further increases in credit spreads are therefore very likely, and this, coupled with further increases in policy rates, will result in significantly higher refinancing costs for companies. As a result, companies with low

margins in cyclical sectors and high refinancing needs are particularly vulnerable in the next 12 to 18 months.

Equities: The end of the slide?

Review: The third quarter was characterised by strong price fluctuations. The MSCI World Index rose almost 12% from the beginning of July to mid-August, but then a correction set in again and the index fell, resulting in a loss of 6% at the end of the quarter compared to the previous quarter. For many stock markets, this is now the third consecutive quarter of losses. This was last seen during the financial crisis in 2008.

At the end of the third quarter, the year-to-date performance of the EuroStoxx 50 and SMI was -21% and the S&P 500 -25%. Emerging market stocks, meanwhile, lost 29% since the beginning of the year.

Stronger interest rate hikes by central banks and Europe's energy crisis are two main triggers of the recent correction.

Chart 4

Equity Markets

Sources: Baloise Asset Management, Bloomberg Finance L.P., as of 05.10.2022

Outlook: The outlook for the fourth quarter is gloomy, as high inflation, rising key interest rates and recession risks are likely to continue to weigh and fuel uncertainty in the market. We therefore expect the current downward trend to continue. However, short-term recovery phases, as seen most recently in July, cannot be ruled out.

There are likely to be strong differences in performance at the sector level. While the energy sector benefits from high commodity prices, the share prices of companies in the communications or IT sectors tend to be under the most pressure due to the interest rate turnaround and rising recession risks. In the past, stocks from the consumer staples or healthcare sectors have proven to be more resilient in such market phases.

Currencies: The greenback is back

Review: Foreign exchange markets saw strong turbulence in the last quarter. The last time such high volatility was seen was at the beginning of the pandemic. The result was intervention by governments and central banks.

Among the currencies of advanced economies, the Japanese yen is one of the biggest losers of the year. Unlike Western central banks, the Japanese central bank sticks with its ultra-loose monetary policy. When the currency came close to cracking the 145, a depreciation of over 25% since the beginning of the year, the government intervened. To stem the slide, the Japanese Ministry of Finance bought yen appreciated to the tune of $20 billion. There was a brief appreciation of the yen, but by the end of September the rate was back at JPY 144.75 per US dollar.

Market intervention was also needed in the UK. The announcement of the government's tax reform plans triggered a sell-off of the pound. Within three trading days, the currency lost over 8% intraday against the US dollar. The Bank of England's intervention in the bond market stabilised the British financial markets and consequently the pound (see section "Bonds").

The euro also showed weakness in recent months. In view of the economic risks emanating from the energy crisis, it lost 6.5% against the US dollar and 3.4% against the Swiss franc over the summer months. At the end of the quarter, the euro was thus below parity with the franc (0.96740 francs).

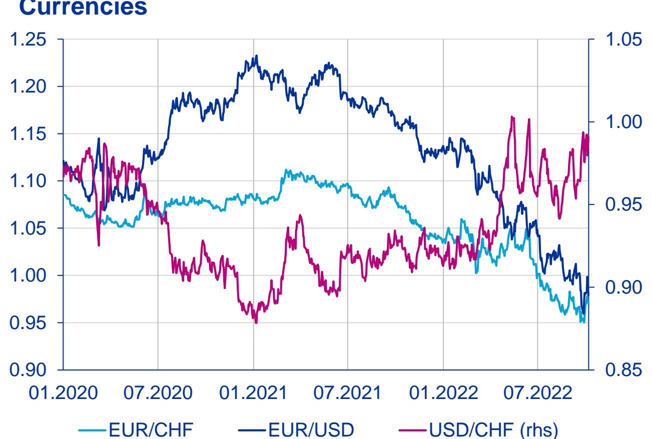
The Fed's rate hikes and the still relatively robust US economic situation are giving the US dollar a tailwind and led to an appreciation of the trade-weighted US dollar of 7.1% in the third quarter.

Outlook: We expect the US dollar to hold on to its strength in the next quarter, thanks to the Fed's clear policy.

Although the ECB should catch up with interest rate hikes, we expect the euro to remain under pressure. This is because the euro area is most affected by the current energy crisis and a vulnerable geopolitical escalation in Ukraine. In this environment, the Swiss continues to benefit as a safe haven. In short, we expect the euro to remain below parity with the Swiss franc at the end of the year.

Chart 5

Currencies



Sources: Baloise Asset Management, Bloomberg Finance L.P., as of 05.10.2022

Real Estate Switzerland

Review: The SNB's interest rate hike of 75 basis points in September was already largely priced in by the financial markets before the decision. In some cases, an increase of 100 basis points was expected. This can be seen from the fact that the SXI Real Estate Funds Broad Total Return Index, among others, recovered after the interest rate decision on 22 September 2022. Thus, before the interest rate decision (on 21 September 2022), the index closed with a year-to-date performance of -23.2% and thus at this year's low. After the interest rate decision, the index recovered somewhat and closed at -16.8% on 30 September 2022.

The interest rate development is also noticeable in the direct real estate market. The yield compression in transactions has stopped in the meantime.

Chart 6

Real estate funds Switzerland

550
500
450
400
350
300
2016 2018 2020 2022

SXI Swiss Real Estate Funds Total Return Index

Sources: Baloise Asset Management, Bloomberg Finance L.P. , as of 05.10.2022

Outlook: Interest rate developments will remain the focus of real estate investors in the coming quarter. Rising borrowing costs on the one hand and higher yields on other investments on the other could increase the pressure on real estate prices.

Via the reference interest rate, rising interest rates will have a positive nominal impact on rental income from residential properties. After the reference interest rate has only fallen since its introduction in 2008, the first increase is likely to take place in the coming months. From the owner's point of view, it should be noted that the increase can only take place to an extent that the market also absorbs.

The high inflation rate will also have a positive effect on the nominal income of properties, especially in the case of commercial leases. The extent to which inflation can be passed on to the tenants is regulated individually in the rental contracts. In addition, the market rents of the individual spaces also impose upper limits.

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