Market Outlook 4th Quarter 2021

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Economic outlook

- The global economic recovery has passed its peak. We expect further recovery to vary regionally, as it will be shaped by local vaccination progress, dependence on manufacturing and the speed of global supply chains normalising.
- Persistent bottlenecks caused inflation to rise sharply across the globe. A reversal of this trend is not expected until 2022.

Financial market implications

- Monetary policy is becoming less expansionary, causing long-term interest rates to rise.
- However, real interest rates remain negative in many places, which continues to fuel the hunt for yield. Equities, corporate bonds and real estate thus remain attractive in relative terms, but amid rich valuations selectivity is key.

Risks

- Low vaccination rates in emerging markets threaten the normalization of global supply chains and production capacity, which in turn could delay an easing of inflationary pressure.
- If temporary price rises were to turn into sustained price pressure with sharply rising interest rates, there would be price corrections on the financial markets and the economic recovery would be stalled.
- The emergence of new vaccine-resistant virus mutations would result in new lockdowns. For markets, such a scenario would be negative across the board. However, a renewed rapid response from central banks and fiscal policy would be expected.

Global Economy: Not short of shortages

Global economic momentum is slowing, but the recovery is likely to continue. Covid restrictions easing and vaccination progress, especially in developed countries, led to a strong, mid-year global economic rebound. However, the global Purchasing Managers' Index (PMI) has weakened in recent months after hitting a 15-year high in May (58.5 points).

In September, the index stood at 53 points and thus still points to a global expansion of economic activity. However, supply bottlenecks and the resulting higher costs are increasingly putting the brakes on growth.

A number of factors have triggered these bottlenecks and delays:

- Strong demand in the face of the economic reopening has led to a record number of cargo ships jamming outside ports. This, together with a shortage of freight containers, has led to skyrocketing freight costs (chart 1).
- Global production capacity remains constrained due to the pandemic. In addition, regional covid outbreaks in emerging markets with low vaccination rates, especially in Southeast Asia, are delaying the rebuilding of these capacities. This is a risk that we already addressed in our last market outlook.
- Power outages in various regions of China, the world's manufacturing hub, have further added to the supply shortages.

Chart 1

Surging freight costs

WCI composite container freight benchmark in USD per 67m³ container

Sources: Baloise Asset Management, Bloomberg Finance L.P. as of 11.10.2021

Private consumption, the main driver of the recovery, is also losing steam. On the one hand, the wealth saved during the lockdowns has already been spent once the economy reopened, meaning that significant additional catch-up effects are not to be expected. On the other hand, household confidence in the major economies has dimmed slightly in light of high inflation rates and the ongoing pandemic. In other words, consumers have become somewhat more hesitant again with regard to major spending.

Thanks to the progress made with vaccinations and the continuing accommodative economic policy measures, we expect the recovery to continue, even if it is likely to be less dynamic than in recent months and to vary in strength depending on the region and sector.

With regard to inflation, our baseline scenario assumes that production capacities can be further expanded and that consumers will increasingly shift their consumption from goods to services. The supply bottlenecks should thus ease somewhat over the next few quarters and as a result inflation should also fall again. However, this scenario for the global economy is subject to a high degree of uncertainty, as the duration of the bottlenecks is difficult to estimate and also varies depending on the product or supply route. In addition, lagging vaccinations continue to pose a risk for emerging markets and the normalisation of global supply chains and, consequently, inflation rates.

Switzerland: The corona-induced economic slump has been overcome. The pre-crisis level of Swiss gross domestic product was probably exceeded in the 3rd quarter. The labour market is also improving steadily. In September, the unemployment rate was 2.6%, around 1 percentage point below the 2020 peak, and while still above the pre-crisis low of 2.1%, it is lower than the rates we saw in 2012-2017. However, Switzerland cannot escape global trends. Weaker foreign demand and shortages of certain inputs for industry have therefore led to a slowdown of the boom in the Swiss economy.

Inflation was 0.9 percent in September. This is 1.7 percentage points above the previous year's level. We expect inflation to pick up somewhat further in the coming months, but do not believe that inflation will rise much above the 1 percent mark.

Overview of figures, in % compared to previous year

	2020	2021	2022
GDP growth	-2,7 %	3,50 %	3,00 %
Inflation (year-end value)	-1,7 %	1,20 %	0,65 %

USA: The economic and political environment is becoming more challenging. In the dispute over the debt ceiling in the US, Democrats and Republicans have reached an agreement. This has averted a US default at least until the beginning of December 2021. By then, however, new measures will be needed to secure the government's financing.

Thanks to favourable financing conditions and a supportive fiscal policy, the US economy was able to record an extremely dynamic recovery by international standards. In the first seven months of the year, an average of 636,000 new jobs were created each month. This progress has slowed considerably in recent months. In September, only 194,000 new jobs were filled. The culprits are the delta variety on the one hand and labour market frictions on the other.

Many companies report that it is currently difficult to find suitable workers, as supply is outstripping demand. In August, the nearly 10.4 million jobs advertised were matched by only 8.4 million job seekers. Various factors are keeping some Americans from taking a job even though they would be readily available. These include fear of Covid-19, mandatory vaccinations by certain employers, lack of child care and, until recently, increased unemployment benefits.

This skills shortage is putting upward pressure on wages and thus inflation. However, the biggest drivers of inflation can still be attributed to special effects, such as the chip shortage and the economic reopening.

We expect inflation to peak this year and overall, as measured by the consumption deflator, to still be well above the Fed's long-term target of 2.0 percent at the end of the year. A moderation in price pressures is then to be expected for 2022.

Overview of figures, in % compared to previous year

	2020	2021	2022
GDP growth	-3,5 %	5,90 %	4,10 %
Inflation* (year-end value)	1,2 %	4,20 %	2,00 %

* As measured by the consumer deflator.

Eurozone: Moderation at a high level. Towards the end of the summer, the economic boom lost momentum. The latest PMIs show that countries such as Germany, which rely heavily on the manufacturing sector, are for once lagging. In contrast, the economic slowdown was more moderate in service-oriented member states such as Ireland and Spain. In the aggregate, however, robust economic growth is still expected in the euro area, thanks in part to an expansionary central bank policy and the EU's multi-billion euro COVID 19 (Next Generation EU) rescue fund.

The unemployment rate continued to fall and, at 7.5% in August, was only 0.4 percentage points above the pre-crisis level. However, wages and non-wage labour costs in the euro area contracted by 0.1% year-on-year in the summer. This contrasts with fears that the recent acceleration in inflation and an improved labour market could lead to higher wage demands from workers. However, wage negotiations in the coming months are likely to reverse this trend.

Inflation reached 3.4 % in September. However, around 44 % of this increase is purely due to energy price developments. Above average rates are still to be expected towards the end of the year, before inflation subsides somewhat in 2022.

Overview of figures, in % compared to previous year

	2020	2021	2022
GDP growth	-6,5 %	5,00 %	4,30 %
Inflation (year-end value)	-0,3 %	3,20 %	1,30 %

China: Various stumbling blocks on the road to recovery. For years, economists have been warning about the risks of the bloated real estate sector. The Evergrande crisis has now brought them to light again. The real estate sector, including the related services, accounts for nearly 30 % of China's GDP and is thus of great importance. In order to prevent adverse effects for private consumption, we assume that the government will try to avert a collapse in property prices. According to Moody's estimates, the bulk of Chinese household wealth is tied up in real estate (around 70-80%). But even if the sector cools down, this will have negative consequences for the overall economy in the short term. More on this in the following focus topic.

Further covid 19 outbreaks followed by lockdowns, as well as a series of power outages, have forced factories in various regions of China to temporarily curtail or completely halt production. This has put additional pressure on the Chinese economy, especially as the economic recovery in recent months has been primarily driven by manufacturing and exports. The expected GDP growth for the current year has therefore been revised downwards by most analysts.

Rising raw material prices and high freight and shipping costs have pushed producer prices up sharply. However, this increase has so far only been passed on to consumers to a limited extent. Consumer price inflation in September was a meagre 0.7%.

Overview of figures, in % compared to previous year

	2020	2021	2022
GDP growth	2,3 %	8,30 %	5,50 %
Inflation (year-end value)	0,1 %	2,10 %	2,25 %

Monetary policy: the foot is slowly being taken off the gas pedal

Inflation has risen worldwide. Drivers include higher commodity and food prices, as well as an imbalance between supply and demand, creating shortages. In certain emerging markets, currency devaluations have also played a key role.

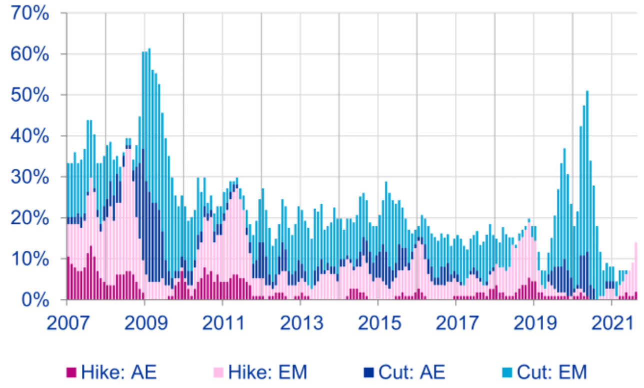
While central banks in emerging markets such as Brazil, Russia or Mexico have therefore already began hiking interest rates, central banks in most advanced economies are more hesitant (chart 2). Their assessment remains that the rise in inflation is temporary. In this case, a tightening of monetary policy would stifle the economic recovery.

In September, the **US Federal Reserve** (Fed) revised its inflation forecasts upwards and emphasised that substantial progress had been made with regard to the employment mandate and the inflation target. A tapering of the bond-buying program could therefore begin as early as November. Currently, the central bank is still buying USD 120 bn of bonds per month. Fed Chairman Jerome Powell said at the last Fed meeting that the purchase program could end as early as mid-2022 if the recovery of the economy and especially the labour market remains robust. Accordingly, half of the Fed officials consider a first rate hike at the end of 2022 to be appropriate. The other voting members would prefer to wait until 2023.

Chart 2

Rising Policy Rates

Share of global central banks, which either cut or hiked their rates at their last meeting, 3 month moving average



Note: Central banks included in the analysis: Argentina, Australia, Brazil, Canada, Switzerland, Chile, China, Colombia, Czech Republic, Denmark, United Kingdom, Hong Kong SAR, Hungary, Indonesia, Israel, India, Iceland, Japan, South Korea, Mexico, Malaysia, Norway, New Zealand, Peru, Philippines, Poland, Romania, Serbia, Russia, Saudi Arabia, Sweden, Thailand, Turkey, United States, Eurozone, South Africa.
Sources: Baloise Asset Management, BIS as of 10.10.2021

The **European Central Bank** (ECB) is somewhat more hesitant. It announced in September that in Q4 2021 it intends to slow down the pace of bond purchases under the emergency purchase programme (PEPP) introduced during the pandemic. However, this doesn't quite compare to the Fed's tapering as the total volume of PEPP, which runs until at least the end of March 2022, will remain unchanged at EUR 1,850 bn. The long-term bond purchase programme (APP), in which EUR 20 bn of securities are purchased every month, will also not be adjusted and is set to continue until shortly before a hike in policy rates.

The latest inflation forecasts of the **Swiss National Bank** (SNB) show that after a moderate increase in the coming months inflation will remain below the 1 percent mark in 2024, even assuming that the key interest rate remains at -0.75 percent. Thus, despite extraordinary effects, inflation dynamics are in line with the objective of price stability. It is therefore likely to be some time before the end of negative interest rates in Switzerland.

There is a risk that the inflationary pressures observed in some advanced economies will turn out to be persistent, forcing major central banks to scale back their loose monetary policy more quickly than expected. This would result in a significant financial market volatility.

Focus: Sword of Damocles hangs over Chinese economy

After decades of seemingly endless growth, the Chinese economy is at a crossroads. Whereas the influence of the state, especially through its strong support for infrastructure projects, was once considered a blessing, this has changed dramatically in recent months. The government's five-year plan implemented this year marks a shift away from highly quantitative growth targets towards more sustainable growth. The central theme is "common prosperity". Consequently, the state is increasing influencing the most powerful industries.

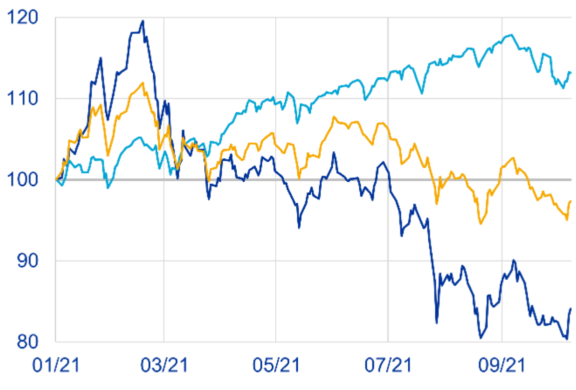
In particular, those companies that have listed on a foreign stock exchange or that abuse their market power are targeted by government regulations.

One example of the government's new course can be seen in the highly indebted real estate sector. Evergrande, China's second-largest real estate company, owes its creditors around $300 billion and is on the verge of bankruptcy. Due to the strong real estate boom, more and more large projects in China were financed with debt. For this, Evergrande had to borrow money from banks, investors as well as potential home buyers. Recently, however, the Chinese government adjusted the guidelines for the debt ratio of companies, because as Xi Jinping has often emphasized "houses are for living, not for speculating". Evergrande thus faced liquidity constraints.

Chart 3

Chinese equities vs. the world

Prices indexed at 100 = value of 31.12.2020



Source: Baloise Asset Management, Bloomberg Finance L.P., as at 11.10.2021

Most of the debt is held by Chinese banks, and the limited integration of Evergrande and the Chinese banking market into the international financial system should limit the global impact of a default.

Another well-known example is the failed IPO of Ant Financial, the financial arm of tech giant Alibaba. After a long wait, the IPO was approved by Chinese authorities in October 2020, only to be cancelled two days before the scheduled IPO. This year, tech companies have been increasingly confronted with new regulations aimed at combating monopoly practices and improving data protection.

These interventions have clear financial consequences. Chinese equities, as measured by the MSCI China Index, for example, lost around 16% of their value between the beginning of the year and mid-October, while the global equity market recorded an increase in value of 13% (chart 3).

In the longer term, this change of course by the government may well have positive consequences for China's economy. For example, efforts to reduce the high level of debt in the real estate sector will reduce systemic financial risk.

In addition, China is to some extent trying to avoid the economic policy mistakes of other countries. For example, the partially dominant position of technology and financial companies in Western economies has been denounced for some time, but has not been tackled with any consistency. The greatest challenge will probably be not to stifle the free market economy and the associated innovation too much, but at the same time to establish certain limits.

Bonds: Rising interest rates but no Evergrande spillover

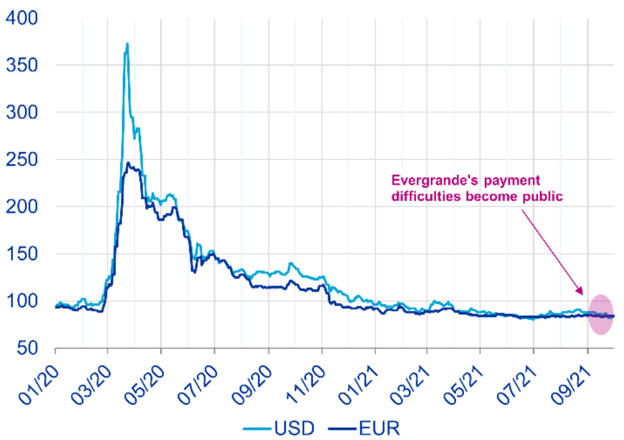
Review: The Fed and other central banks are signalling that they want to cautiously take their foot off the gas pedal a bit. ECB President Christine Lagarde remains more cautious. She recently stressed that a monetary policy overreaction, in other words an overly restrictive monetary policy, could jeopardise the economic recovery in the euro area (see section on "Monetary policy").

Interest rates reacted accordingly to the Fed's comments. The yield on 10-year US government bonds rose by 18 basis points (bp) in September 2021 alone, reaching 1.60% by mid-October. Despite the ECB's more cautious tones, the 10-year German Bund also rose by 18 bp during this period, climbing to -0.12% by mid-October.

Chart 4

Corporate bonds: credit spreads

In basis points



Sources: Baloise Asset Management, Bloomberg Finance L. P., as of 30.09.2021

On the credit front, there were briefly major concerns when the payment difficulties of China's second-largest real estate developer, Evergrande Group, became public. However, the involvement of foreign banks is limited, which is why major upheavals in the international financial markets failed to materialise. Despite this news, credit spreads on EUR and USD bonds moved sideways and remain at their historically low levels (see chart 4).

Outlook: As of September 2021, global interest rates have risen significantly and we do not see a return to materially lower levels in the medium term. Rather, we expect central banks to gradually return to a more restrictive monetary policy. With the prospect that the Fed, for example, will begin to gradually reduce its bond purchases as early as November of this year, we see potential effects on the level of interest rates in the European Monetary Union. However, the pressure on interest rates in Europe could be somewhat more muted than in the USA. Due to the highly indebted peripheral countries in Europe, the ECB will try to ensure that interest rates do not exceed a level that would make the national debt of these countries, which has risen again as a result of the Corona crisis, unsustainable.

Given rising vaccination rates, we do not expect credit spreads to widen significantly in Q4 2021. If supply chain difficulties and goods shortages persist and thus sustainably dampen the strong positive economic growth forecast in the US and the euro area, credit spreads could come under some pressure, making the historical lows just observed a thing of the past again.

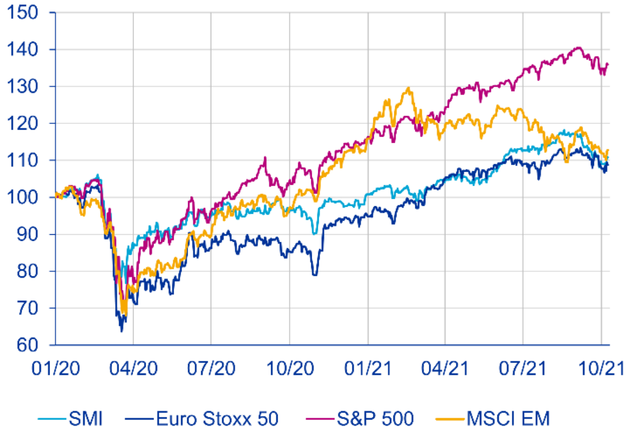
Equities: Heightened volatility

Review: After an encouraging 1st half, daily price fluctuations increased in the 3rd quarter. Concerns about global economic growth, the inflation outlook and China's real estate market unsettled investors. As a result, the global equity market, as measured by the MSCI All Country Index, lost 1.5 % in Q3. Over the year, however, the performance of most major markets looks positive. The performance of the Swiss Market Index (SMI) since the beginning of the year was 8.8% at the end of September. The Euro Stoxx 50 and the S&P 500 were particularly strong during this period, with performances of 13.3% and 15.4% respectively. The situation looks worse for emerging markets. Higher interest rates and drastic pandemic measures due to low vaccination rates weighed on these countries. China's weakness was another major drag, as China accounts for around 34% of the MSCI Emerging Markets Index (see focus topic).

Outlook: The low interest rate environment, which remains intact especially in Europe, and robust corporate earnings performance continue to support markets. However, the strong positive stimulus from monetary policy and the economic reopening that we saw at the beginning of the year is fading. Surprisingly high inflation rates are an additional burden for equities in the coming months, as rising costs put pressure on margins and thus on profits if companies cannot pass them on to their consumers (chart 6).

Chart 5

Stock market development



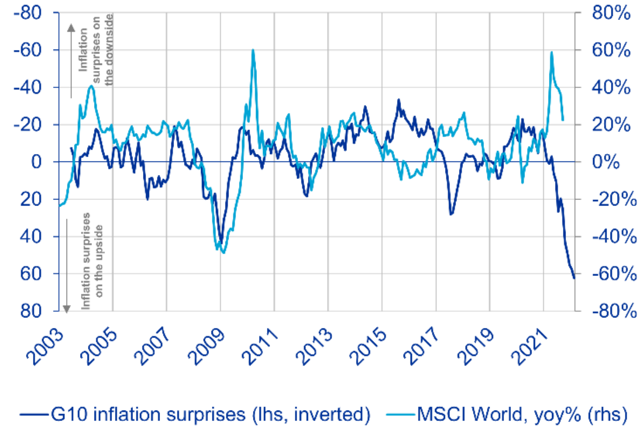
Sources: Baloise Asset Management, Bloomberg Finance L. P., as of 11.10.2021

Valuations have recently come down somewhat due to price declines, but are mostly still expensive. Emerging market equities are currently attractive from a valuation perspective compared to developed markets and their own history. However, the situation in China is a cause for concern and poses significant risks for other emerging markets (see focus topic).

In this environment, we expect higher price fluctuations than in the first half of the year. Specifically, we see the inflation trend and the Fed's tapering as sources of further volatility on the stock markets.

Chart 6

Inflation weighs on equities



Sources: Baloise Asset Management, Bloomberg Finance L. P., as of 11.10.2021

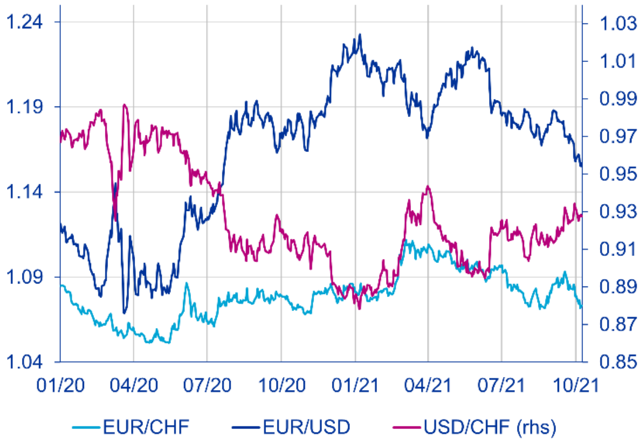
Currencies: USD strength thanks to monetary policy

Review: On a trade-weighted basis, the USD dollar gained 1.9% in Q3. Thus, as of the end of September, the greenback stood at 0.9317 francs and per euro there was 1.1580 USD. An important driver of this development is that the US Federal Reserve is ahead of the EU and Switzerland in terms of interest rate policy.

In the same period, the Swiss franc gained around 1.7 % against the euro. This was particularly the case in the days when increasing uncertainty was spreading across the market and investors were thus looking for safe havens.

Chart 7

Development of currencies



Sources: Baloise Asset Management, Bloomberg Finance L. P., as of 11.10.2021

Outlook: Thanks to the interest rate advantage, USD strength should continue until the end of the year. At the beginning of October, analysts surveyed by Bloomberg expected a EUR/USD rate of 1.16 and a USD/CHF rate of 0.93 by the end of the year.

As we expect the market environment to remain rather volatile, the recent appreciation of the Swiss franc vis-à-vis the euro should also ease only slightly. However, the franc should not experience too much upward pressure either, as the Swiss National Bank is still prepared to intervene in the currency market. Moreover, the interest rate outlook for Switzerland is in line with that of the euro zone. We therefore expect the EUR/CHF exchange rate to move sideways.

Real Estate Switzerland

Review: Real estate investments continue to be supported by the ongoing low interest rate-induced investment emergency. Real estate funds have recovered much better from the Corona crisis than real estate equities. Funds had reached new record highs of +9.2% during 2021 and fell again in September 2021, ending the quarter with a performance of 6.6% (see chart 8).

Unimpressed by the corona virus, the rental housing market continues its soft landing. Investors continue to prefer residential real estate regardless of the development of rents and vacancy rates as well as falling yield expectations. The minimum real discount rate of a new mid-sized residential investment property in a prime location in Zurich was 1.81% in August 2021. Compared with 1.89% in January 2021 and 1.88% in April 2021, this has fallen by around 8 basis points.

Chart 8

Swiss real estate

Sources: Baloise Asset Management, Bloomberg Finance L. P. , as of 11.10.2021

Outlook: The office space market remains stable for the time being in terms of the development of office rents (transaction rents). In the medium term, an increase in vacancies can be expected despite the decline in supply, given the great uncertainty regarding the space requirements of companies in the wake of the pandemic and the home office recommendation. At the same time, the space requirements lost through home office are likely to be partly compensated again by companies through encounter zones if employees are on site at the same time.

The individual segments of the retail sector have been affected very differently by the Corona crisis. While the food and electronics retail sectors recorded large increases compared to previous years, non-food areas such as shoe and clothing retail experienced large declines in sales. In addition to online shopping and shopping tourism, COVID is likely to further accelerate the decline of brick-and-mortar retail in Switzerland. During the Corona crisis, vacancy rates for retail space in Switzerland settled at between 5% and 6%. In the stationary retail sector, a wave of bankruptcies was prevented (for the time being) thanks to government support measures (short-time work compensation, COVID loans and hardship payments) and rent reductions on the part of landlords. Currently, there are already initial signs that vacancies in retail space will increase in the medium term as soon as the state subsidies cease.

Editorial

Melanie Rama
Senior Economist, Investment Strategy
melanie.rama@baloise.com

Philip Karstens
Real estate portfolio manager (third-party mandates)
philipp.karstens@baloise.com

Dominik Schmidlin
Head of Investment Strategy
dominik.schmidlin@baloise.com

Dominik Sacherer
Junior Credit Analyst
dominik.sacherer@baloise.com

Alexander Wallach
Trainee, Investment Strategy
alexander.wallach@baloise.ch

Blaise Roduit
Head of Fixed Income
blaise.roduit@baloise.com

Baloise Asset Management Switzerland Ltd
Aeschengraben 21, 4002 Basel
www.baloise-asset-management.com

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