Market Outlook 2nd Quarter 2022

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Economic outlook

- The war in Ukraine is dampening economic growth and boosting inflation worldwide.
- To curb inflation, central banks are tightening policy accordingly.

Financial market implications

- The list of disruptive factors is long. We expect increased volatility in the second quarter.
- Rising interest rates reduce the relative attractiveness of shares and real estate funds somewhat.
- Selectivity in investing becomes even more important.

Risks

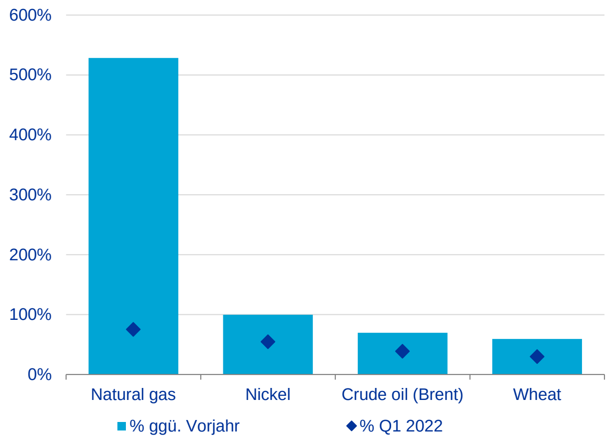
- China's zero-covid approach is not only putting a strain on the production capacities of the second largest economy, but also on global supply chains. This in turn delays the normalization of inflation dynamics.
- At the same time, too strong a course correction by the central banks harbours the danger of stifling growth with the interest rate hikes.

W economy: Rising prices

The escalation of the Ukraine-Russia conflict led to striking distortions on the commodity markets. After all, Russia is the world's third largest energy producer and Ukraine is considered the "breadbasket" of Europe.

Oil prices rose by almost 39% in the first quarter. Agricultural commodities, such as wheat, are now 34% more expensive than at the beginning of the year. One of the biggest price jumps, however, was seen in European natural gas, whose price rose by a whopping 86% in the first quarter. This corresponds to a fivefold increase compared to the previous year (see chart 1).

Chart 1
Rising raw material prices



Sources: Baloise Asset Management, Bloomberg Finance L.P. , as at 06.04.2022

The already high inflation rates worldwide will thus be further fuelled. The rise in inflation is likely to be strongest in countries where households spend a large share of their income on food and energy. Our analysis shows that this is particularly the case in the Baltic states and parts of Southern Europe.

Geopolitical tensions have further lowered consumer and business confidence, which has already been affected by inflation.

The consequences for the global economy are lower growth and higher inflation. The recent rise in corona infections in China and the resulting lockdowns further accentuate these trends.

Switzerland: **Recovery somewhat slowed.** The direct economic impact of the Ukraine war is likely to be limited for Switzerland, as economic ties with Russia and Ukraine are low. The EU, on the other hand, which is more exposed to the conflict, is one of Switzerland's most important trading partners. An economic downturn in the monetary union would hit Swiss manufacturing. Surveys show therefore that the war is also causing uncertainty among Swiss companies as a result. This in turn affects investment activity. Thus, the KOF economic barometer recently fell from 105 to 99.7 points, which signals a slowdown in economic growth. The situation on the labour market, however, shows that the economy is still on very robust footing. The seasonally adjusted unemployment rate was 2.2% at the end of March, below the pre-Corona pandemic level of 2.3% in February 2020.

Inflation was 2.4% in March, above the Swiss National Bank's target range. A large part of this development is due to higher energy prices. Inflation excluding fresh and seasonal products, energy and fuel, the so-called core inflation, was 1.4 %. We expect inflation to rise somewhat further in the coming months, driven by higher prices for energy and imported goods.

Figures at a glance, in % compared to previous year

	2021	2022	2023
GDP growth	3,8 %	2,7 %	1,8%
Inflation (year-end value)	1,5 %	1,5 %	0,7 %

USA: Real wages fall. The exceptionally strong labour shortage in the USA continues. In February, the almost 11.3 million advertised jobs were matched by only 6.3 million job seekers. As a result, wages continue to pick up. In March, wage growth was 5.6% year-on-year. This is well above the average growth of 2.4 % before the Corona crisis. However, inflation is growing even faster, leading to declining purchasing power. Consequently, surveys by the University of Michigan show that consumer sentiment hit an 11-year low in February. The expected interest rate hikes by the Federal Reserve are also likely to take some of the momentum out of economic development in the medium term. Economic growth in the USA is therefore likely to lose momentum over the year.

We expect inflation, as measured by the personal consumption expenditures deflator, to rise further in Q2 before easing again towards the end of the year. However, it should still be significantly above the Fed's long-term target of 2 % on average at the end of the year.

Figures at a glance, in % compared to previous year

	2021	2022	2023
GDP growth	5,7 %	3,3 %	2,2 %
Inflation* (year-end value)	5,3 %	4,0 %	2,6 %

* Measured at the PCE deflator.

Eurozone: Significant economic risks. The euro area is heavily affected by the war due to its high dependence on Russian energy supplies. This, coupled with ongoing material shortages and rising commodity prices, has clouded the economic outlook for the euro area. The eurozone manufacturing PMI fell to a 14-month low in March, pointing to further weakening in the sector. At the same time, the European Commission's consumer confidence index fell to May 2020 levels, reflecting heightened consumer uncertainty that is likely to manifest itself in lower retail sales in the medium term.

However, the situation on the labour market remains encouraging. In February, the unemployment rate fell below the pre-pandemic level and stood at 6.8 %.

Inflation reached 7.5 % in March. The bulk of this increase, 4.5 percentage points, is still due to energy price developments. In view of the geopolitical risks and their consequences for the commodity markets, further price increases for energy and food are likely to push up inflation rates in the euro area in the coming months.

Figures at a glance, in % compared to previous year

	2021	2022	2023
GDP growth	5,3 %	3,0 %	2,5 %
Inflation (year-end value)	5,0 %	5,1 %	1,6 %

China: The zero-covid approach weighs on the economy. The Chinese government announced an economic growth target of 5.5 % for the current year at the beginning of March. However, this can hardly be achieved without additional stimulus measures from the government and the central bank. Growth has already weakened in view of the real estate crisis last year. The recent rise in covid cases in China has also made it clear that China's strict covid policy is clearly slowing down the economy. The lockdowns in Shenzhen and Shanghai, two major economic hubs, are significantly dampening production and consumption. The Caixin manufacturing PMI thus fell below the growth threshold of 50 points and, at 48.1 points, is at its lowest level since spring 2020.

Rising raw material prices and high freight and shipping costs have also driven up producer prices in China. They are currently 8.8% higher than in the previous year. Unlike in many other countries, however, this increase is hardly being passed on to consumers. Consumer price inflation in February was only 0.9%.

Figures at a glance, in % compared to previous year

	2021	2022	2023
GDP growth	8,1 %	5,0 %	5,2 %
Inflation (year-end value)	1,5 %	2,5 %	1,8 %

Monetary policy: the reins are tightened

The prospects of lower growth and higher inflation at the same time mean that monetary policy is increasingly becoming a tricky balancing act for central banks.

Tightening key interest rates too quickly could stifle economic growth. On the other hand, if policy is too lax, there is a risk of runaway inflation.

Central banks currently assess inflation as a greater risk than the possible decline in growth. Therefore, interest rates are to be raised faster than communicated at the beginning of the year.

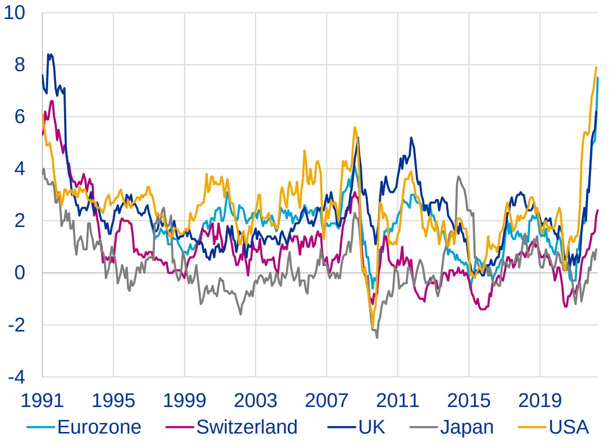
In mid-March, the **US Federal Reserve** (Fed) raised the policy rate by 25 basis points for the first time since 2018. This is now in the range of 0.25 % to 0.5 %. For the rest of the year, the Fed has signalled rate hikes of another 150 basis points, with the bulk coming in the next few months. Fed officials said that a 50 basis point rate hike at the next meeting in May would be appropriate to curb inflation more quickly. The central bank's balance sheet, which more than doubled during the pandemic, should also be reduced quickly.

As the US unemployment rate fell again in March and has now almost reached the pre-pandemic level of 3.6% (February 2020: 3.5%), the pressure on the Federal Reserve is intensifying. Since the beginning of April, market participants have therefore been anticipating an even stronger rise in interest rates, totalling 200 basis points by the end of the year.

Graph 2

Global inflation rates

in % vs. previous year



Sources: Baloise Asset Management, Bloomberg Finance L.P. , as at 04.04.2022

The European Central Bank (ECB) is also inclined to tighten the reins more quickly in view of rising inflation. In March, ECB chief Christine Lagarde announced that the tapering of the bond-buying programme would be accelerated. The bank is prepared to end the purchase programme as early as the third quarter if inflation dynamics do not ease by then. The ECB is thus keeping the door open for a key interest rate hike at the end of the year.

An interest rate hike on the part of the ECB also creates more leeway for the **Swiss National Bank** (SNB). This would allow the SNB to raise interest rates without further strengthening the Swiss franc. However, the inflation trend in Switzerland is rather subdued in international comparison, partly due to the strength of the franc. The SNB's latest assessments show that inflation should still be above 2% until autumn 2022 in view of higher energy prices but will fall back below the 2% mark towards the end of the year and remain there until 2024. This is even assuming that the key interest rate remains at -0.75%. In view of inflation expectations, a departure from the current monetary policy is therefore not yet imperative.

Bonds: Inversion of the US yield curve

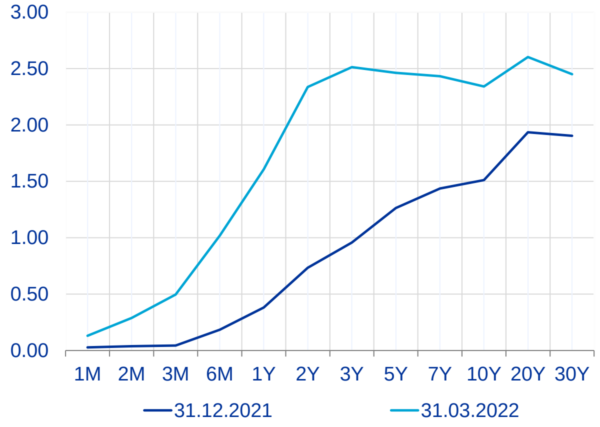
Review: The first quarter of 2022 saw a massive rise in interest rates in the euro area and the US. Given the ongoing positive trend on the US labour market, a faster tightening of monetary policy is becoming increasingly likely (see section on monetary policy). However, the Fed's plan to raise key interest rates by 50 basis points at the next meeting is viewed critically by the market. In the USA, this manifested itself in an inverted yield curve. This phenomenon points to a weakening economic development in the medium term and is already fuelling new fears of recession.

Interest rates on 10-year US government bonds rose by 86 basis points in the first quarter. However, the short end of the curve rose disproportionately, which is why the curve flattened considerably and was even inverted between the 3 and 10-year maturities at the end of March.

Chart 3

US yield curve

in % of



Sources: Baloise Asset Management, Bloomberg Finance L.P., as at 31.03.2022

The situation was similar in the euro area. Here, too, the high level of inflation has persisted. In Germany, the inflation rate for February was 5.1%, and for March 2022 the Federal Statistical Office of Germany even expects an increase to 7.3%. The yield curve of German government bonds also flattened significantly in the first quarter. While the 20-year and 30-year interest rates on German government bonds rose by 59 basis points and 47 basis points respectively, the interest rates on maturities between three and six years increased by over 79 basis points. For investors, this means that they are hardly compensated for the risk of investing in longer maturities.

Outlook: Due to the continuing inflationary pressure, we expect interest rates to continue to rise. In this environment, bonds with shorter durations make it possible to limit sensitivity to interest rate changes.

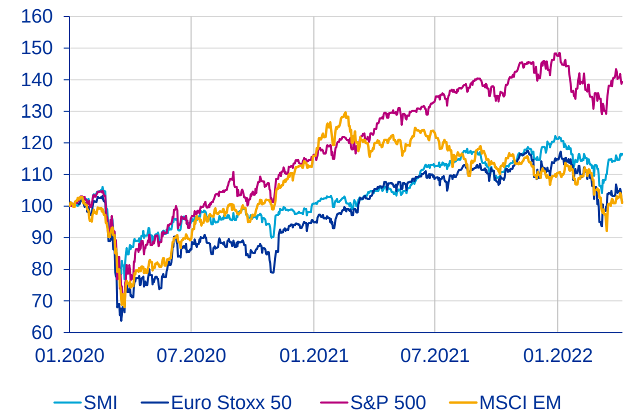
The rise in interest rates in combination with high commodity prices and higher wage demands due to the recovering labour market (especially in the USA) will be a test for the margins of many companies in the medium term. After the strong narrowing of credit spreads since mid-March, we therefore do not see much potential for an even lower level.

Equities: The list of risks is long

Review: The Ukraine war, a volatile commodity market and rising rates led to strong fluctuations on the equity markets. We therefore saw the weakest quarterly performance for equities since the Corona crisis. The setbacks were particularly pronounced for emerging markets and EU stocks, which were at one point down 15% and 18%, respectively. Optimism about peace negotiations between Ukraine and Russia then brought about some recovery on the stock markets. At the end of the quarter, the performance of the EuroStoxx 50 was -9.2% and that of the emerging markets -7.4%. The losses in Switzerland (-6 %) and the USA (-5.5 %) were somewhat less severe.

Chart 4

Equity market development



Sources: Baloise Asset Management, Bloomberg Finance L.P., as at 07.04.2022

Outlook: As long as the Russia-Ukraine conflict is not resolved, geopolitical risks will remain. EU and emerging market equities are most exposed to them.

The current earnings season should reflect the still robust economic environment and sales growth. In the coming months, however, we expect that weakened consumer sentiment and persistently high input costs are likely to weigh on margins and earnings growth. Companies with strong pricing power are best positioned for this environment.

Headwinds for equities are also coming from rising interest rates. Sectors with high valuations (e.g., technology) are coming under pressure. At the same time, equities have benefited greatly in recent years from the investment emergency in the low interest rate environment. In regions where interest rates are soaring, however, equities are gradually losing their relative attractiveness. For example, the dividend yield of the S&P 500, at 1.4%, is now lower than the yield on 10-year US government bonds of around 2.6%.

In Europe, equities are still significantly more attractive from this perspective. Despite the rise in interest rates, dividends in the Swiss and EU markets continue to offer a yield premium compared to 10-year government bonds. For example, the dividend yield of the Swiss Market Index is 2.8%, while the 10-year Swiss yields just under 0.7%.

Currencies: Flight to safe havens

Review: The war in Ukraine led to a significant depreciation of the euro. At the beginning of March, the trade-weighted euro exchange rate was 2.5 % below the level at the beginning of the year. After that, a recovery set in, but by the beginning of April the currency lost value again.

Meanwhile, the Swiss franc and the US dollar benefited from their position as safe havens.

Thus, on 7 March, the euro/franc exchange rate even briefly fell below parity, i.e., the threshold at which the two currencies are worth the same. However, the increase in sight deposits at the Swiss National Bank indicates that the SNB intervened in the foreign exchange market to counteract a further appreciation of the franc. At the end of March, the exchange rate was thus slightly higher again at 1.0212 francs. This corresponds to an appreciation of the Swiss franc of 1.6% in the first three months of the year.

In trade-weighted terms, the US dollar gained 2.8 % in the first quarter. At the end of March, the greenback stood at CHF 0.9225 and USD 1.1067 per euro.

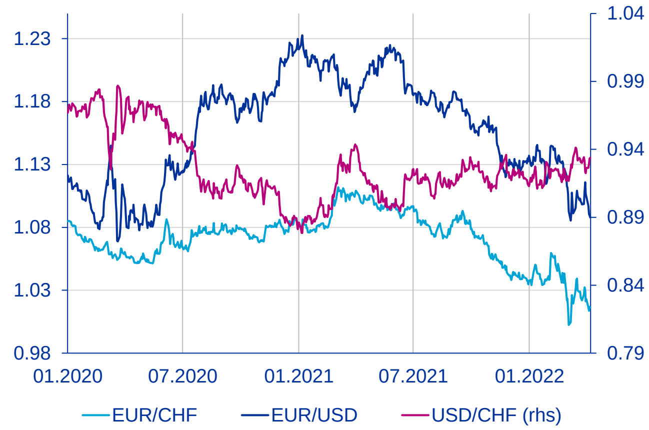
Outlook: Due to covid, inflation fears and the Ukraine war, France's presidential elections have taken a back seat. But these also pose a risk to the euro in the short term. The polls suggest a repeat of the Macron-Le Pen duel, with Macron likely to emerge as the winner. Marine Le Pen, however, has recently caught up in the polls. A victory by Le Pen in the run-off election on 24 April would put additional pressure on the euro.

Even after the presidential elections in France, the Swiss franc is likely to remain a sought-after currency in view of the Russia-Ukraine conflict, especially against the euro.

Regarding the US dollar, we continue to assume that the advantageous interest rate differential between the US and the euro area and Switzerland should support the greenback in the coming months.

Chart 5

Development of currencies



Sources: Baloise Asset Management, Bloomberg Finance L.P., as of 07.04.2022

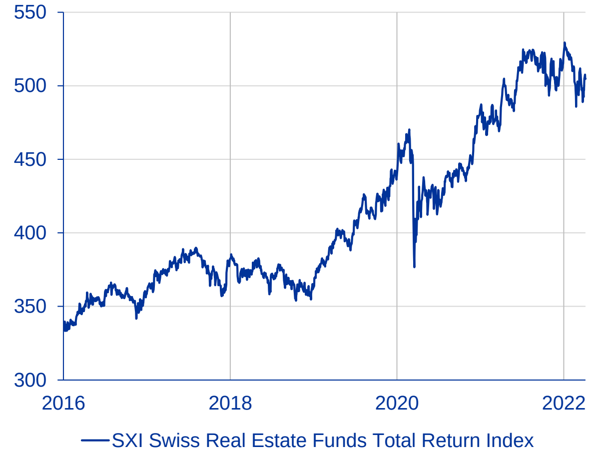
Real Estate Switzerland

Review: Swiss government bonds with a 10-year maturity left negative territory in the last quarter and yielded a nominal 0.67 % at the end of March. The yield spread, i.e. the difference between the prime yields of multi-family houses in Zurich (currently at 1.2 % according to Wüest Partner) and the 10-year German government bonds fell to a level of well below 1%, which is significantly below the long-term average of slightly below 2 % (according to Wüest Partner).

Due to this rise in interest rates and the geopolitical tensions, Swiss real estate funds came under pressure in the first quarter. The performance of real estate funds according to the SXI Swiss Real Estate Funds Total Return Index was thus -4.2% in the first quarter. The index had been declining slightly since the beginning of the year and reached its lowest point in the last quarter with the outbreak of war in Ukraine. Agios from listed real estate funds decreased by 9.7 percentage points this quarter, from 44.5 % to 34.8 %.

Chart 6

Development real estate Switzerland



Sources: Baloise Asset Management, Bloomberg Finance L.P. , as at 06.04.2022

Outlook: At 2.4% most recently, inflation in Switzerland has now also exceeded the Swiss National Bank's (SNB) target range of 2.0%. The cost of energy sources in particular has risen significantly as a result of the Ukraine conflict. This is likely to increase demand for energy-efficient and fossil-free heated properties.

After the rental housing market had been under pressure for years, with supply rents declining and vacancy rates rising, there have recently been some positive signals. On the one hand, construction activity is currently rather restrained. On the other hand, there are positive demand impulses due to immigration and the trend towards more single and small households. This is leading to a shorter period of time for advertisements and lower vacancy rates for rented flats. Compared to the situation before the pandemic, larger flats continue to benefit disproportionately from the recovery.

Despite the lower expected economic growth due to higher inflation, solid employment growth of 1.8 % is still expected for 2022 (forecast by the State Secretariat for Economic Affairs SECO). The positive employment trend should counteract the reduced demand for space due to the trend towards more home offices.

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