Market Outlook 3rd Quarter 2021

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Economic outlook

- The economic upswing, fuelled by pent-up demand, will continue, but depends on heavily on the success of vaccination campaigns and is therefore likely to vary in strength across regions.
- Inflationary pressures are stronger and more sustained in the US than in Europe.

Financial market implications

- The low interest rate environment remains intact, but the peak of the global liquidity wave is behind us.
- Equities, corporate bonds and real estate are often highly valued, but remain relatively attractive.

Risks

- If temporary price rises were to turn into sustained price pressure with rising long-term interest rates, the economic recovery would stall leading to a repricing in financial markets.

- The emergence of new vaccine-resistant virus mutations would result in new lockdowns. For the markets, such a scenario would be negative across the board. However, we'd expected central banks to react swiftly to further ease policy.

Global economy: The upswing

The economic reopening is in full swing in many places. New mutations of the coronavirus caused tighter lockdowns during the winter months. Thanks to the progress in vaccination, restrictions could be eased in Europe and North America. The overall economy is benefiting from this, but it is the service providers in particular who are breathing a sigh of relief.

Accordingly, the global Purchasing Managers' Index (PMI) reached a 15-year high in May and was only slightly below this peak in June. The global economy is thus in a boom phase, which is now increasingly led by the service sector. Manufacturing is also growing, but production is struggling to keep up with the strong demand, as global production capacities are still limited due to the pandemic or have not yet been fully ramped up. The consequences are longer delivery times and rising costs.

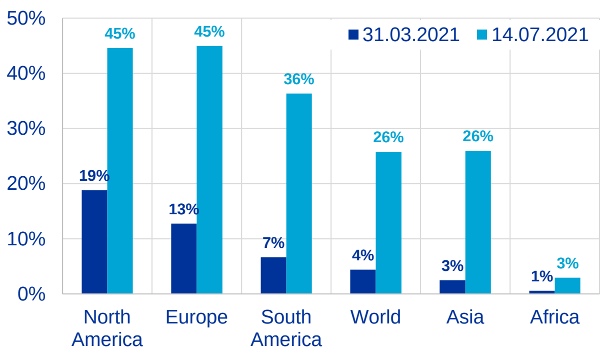
In our baseline scenario, we assume that production capacities can be further expanded and that consumers will increasingly shift their consumption from goods to services. The supply bottlenecks should thus ease somewhat over the next few quarters and as a result inflation should decline again.

However, renewed lockdowns, even if only regional, pose a risk to normalisation because supply chains are ultimately global. One challenge in this regard is the varying speed of vaccination (chart 1). We therefore expect the pace of economic recovery to vary by region and sector. Read more here.

Chart 1

Vaccination rollout

Share of the population that has received one vaccine



Note: Data for China have only been included in the statistics since 10 June.
Sources: Baloise Asset Management, Our World in Data as of 14.07.2021

As can be seen in South America, high vaccination rates alone are not enough to achieve a rapid economic recovery. There the vaccination campaign was accelerated thanks to the Chinese vaccines, Sinovac and Sinopharm. However, studies show that efficacy of these is much lower (in some cases only 50 percent) than those used in industrialised countries. This delays the containment of the pandemic and thus the economic recovery.

With 74% of the world's population yet to receive any vaccination at all, there is also a risk that mutations of the virus will emerge for which the current vaccines offer too little protection, thus jeopardising the further recovery of the global economy.

Switzerland: A dynamic upswing gives hope for a normalisation. Leading economic indicators, such as the KOF barometer or the purchasing managers' indices are close to historical highs. They also show that the recovery of the Swiss economy is increasingly broad-based. It is also encouraging that the crisis instrument of short-time work is losing importance. According to surveys by the company *procure.ch,* short-time work is now used by only 2% of industrial employees. At the height of the Corona crisis, it was just under 3%. The situation has also normalised in the service sector. At the beginning of the year, 18% of the workforce were still on short-time work. Currently it is only 1%.

Inflation was 0.6% in June. This is 1.9 percentage points above the previous year's level. We expect inflation to pick up a little further in the coming months, but do not believe that the 1% mark will be cracked.

Overview of figures, in % compared to previous year

	2020	2021
GDP growth	–2,7 %	3,5 %
Inflation (year-end value)	–1,7 %	0,8 %

USA: The Corona-induced economic slump is over. The US economy is in a strong recovery phase. After the first quarter of 2021, the gross domestic product (GDP) was already only 1% below the level before the Corona crisis. In the second quarter, the economy is expected to have fully recovered. The USA is thus one of the first countries to have overcome the economic effects of covid, measured in terms of GDP. This rapid recovery is due to the containment of the pandemic and the extremely expansive economic policy. At the same time, this raises inflation concerns and the fear that too high inflation rates and interest rates could eventually stifle economic growth. Many companies even report that, despite an unemployment rate of 5.9%, it is becoming increasingly difficult to fill their vacancies. Exceptionally generous unemployment benefits, health concerns and closed schools and childcare facilities have so far inhibited job search activity among workers. These factors will become less important as the additional USD 300 per week in unemployment benefits expires in September. Schools should also reopen nationwide, according to the US Centers for Disease Control and Prevention.

Based on the leading indicators, we expect the expansion to continue over the next few months. However, the momentum of the upswing is likely to weaken. The inflation rate is also likely to decline, as certain base effects will drop out in the current quarter. Overall, inflation, measured by the consumer deflator, should still be well above the Federal Reserve's long-term target of 2.0% on average by the end of the year.

Overview of figures, in % compared to previous year

	2020	2021
GDP growth	–3,5 %	6,6 %
Inflation* (year-end value)	1,2 %	3,5 %

* Measured at the consumption deflator.

Euro area: climbed out of recession trough. Faced with tight containment measures and a weak start to vaccine rollout, the euro area entered a double dip recession at the beginning of the year. The easing of the Corona restrictions revived services. The services PMI recently shot up to a 14-year high. Thanks to simplified travel rules, the region can now also benefit from summer tourism. This is particularly important for member states like Greece, Portugal and Spain, where tourism accounts for between 14% and 20% of GDP.

Inflation did rise significantly, from -0.3% in December 2020 to 1.9% in June 2021, but this is primarily due to one-off effects such as changes in the weightings in the index and exceptional oil price developments. The temporary reduction in German VAT in summer 2020 is also likely to result in a higher inflation rate in July. Rates are expected to remain above average towards the end of the year before these effects subside again in early 2022.

Overview of figures, in % compared to previous year

	2020	2021
GDP growth	–6,5 %	4,5 %
Inflation (year-end value)	–0,3 %	2,7 %

China: Slowing economic momentum. After the rapid recovery last year, growth momentum slowed somewhat this year. However, manufacturing and foreign trade remained the pillars of expansion. Domestic consumption, however, is developing more sluggishly. New regional outbreaks of the virus caused renewed lockdowns, which had a negative impact on travel around the Chinese New Year, for example, and thus also on consumption. The now accelerated vaccination campaign is intended to counteract this in the future. At the same time, the government is gradually reducing the economic stimulus in order to normalise credit supply and contain financial risks.

Rising commodity prices as well as high freight and shipping costs have caused producer prices in China to rise sharply. However, this increase has so far only been passed on to consumers to a small extent.

Overview of figures, in % compared to previous year

	2020	2021
GDP growth	2,3 %	8,5 %
Inflation (year-end value)	0,1 %	2,5 %

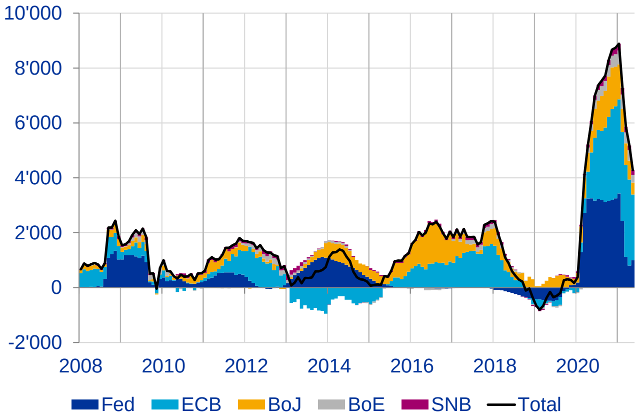
Monetary policy: Low interest rate environment remains intact, but liquidity to slow

The economic recovery from the pandemic has spurred inflation fears. The consensus among central banks remains that the rise in inflation is temporary. A turnaround in policy interest rates is therefore not to be expected in the near future. However, a tapering of quantitative easing is somewhat closer, at least in the USA.

Graph 2

Central Bank balance sheets

12 month rolling sum, in USD billions



Sources: Baloise Asset Management, Bloomberg Finance L.P. , as of 30.06.2021

In March, the **US Federal Reserve** (Fed) still signalled that no interest rate adjustments were to be expected until the end of 2023. In June it revised its forecasts for economic growth and inflation sharply upwards. As a result, it now considers two rate hikes in 2023 to be appropriate. Currently, the central bank is still buying USD 120 bn of bonds per month until substantial progress is made on the employment mandate and inflation target. Given the recovery path of the US economy, we expect a gradual tapering of the purchase programme to be communicated in Q4 and to take place from 2022 onwards.

The **European Central Bank** (ECB) is further away than the Fed from normalising monetary policy. In its monetary policy meeting in June, it promised to keep the pace of bond purchases as high in the current quarter as in the second quarter (approx. EUR 80 bn per month) in order to keep the rise in interest rates in check. As part of its strategic review, the ECB adjusted its inflation target from below but close to 2% to a symmetric inflation target of 2%. With this step, the ECB is signalling that it wants to avoid the mistake of the last crisis, when it raised interest rates too early.

The latest inflation forecasts of the **Swiss National Bank** (SNB) show that inflation will remain below the 1 percent mark in 2023, even assuming that the key interest rate remains at -0.7%. There are therefore no signs of a more restrictive monetary policy in Switzerland. Accordingly, negative interest rates will remain in place for the time being.

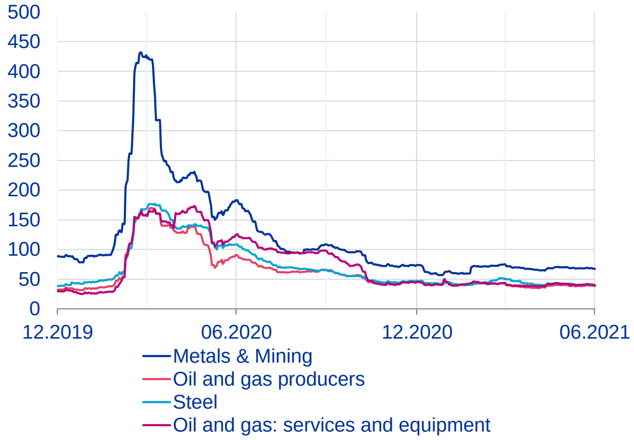
Bonds: Historically low credit spreads

Review: The combination of economic recovery and continued very loose monetary policy is also reflected in corporate bond credit spreads. These have now reached historically low levels across almost all sectors. This can be seen impressively in the mining, steel and oil and gas sectors. The credit premium for euro-denominated corporate bonds in the metals and mining sector, for example, was around 67 basis points at the end of June, already 21 basis points below the pre-crisis level at the end of 2019.

Chart 3

Euro-denominated corporate bonds

In basis points, credit spread (OAS) by sector



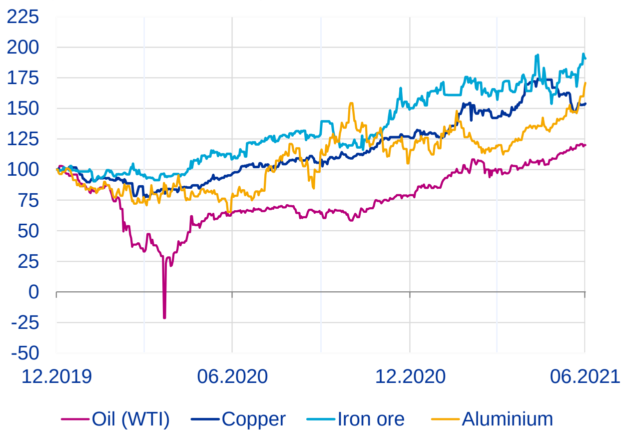
Sources: Baloise Asset Management, Bloomberg Finance L. P., as of 30.06.2021

When the global economy came to a standstill within a few days in March last year as a result of the pandemic, demand for raw materials dropped to an absolute minimum. Falling commodity prices were the result and mine operators and oil and gas producers were forced to suspend production where possible. The situation has since reversed. The global economy has returned to its growth path faster than could have been expected at the beginning of the pandemic. In combination with the significant curtailment of global commodity production in the meantime, we are currently facing a supply shortage and commodity prices have risen very sharply over the last twelve months.

Chart 4

Commodity prices

Price (index 100 = 01.01.2020)



Sources: Baloise Asset Management, Bloomberg Finance L. P., as of 30.06.2021

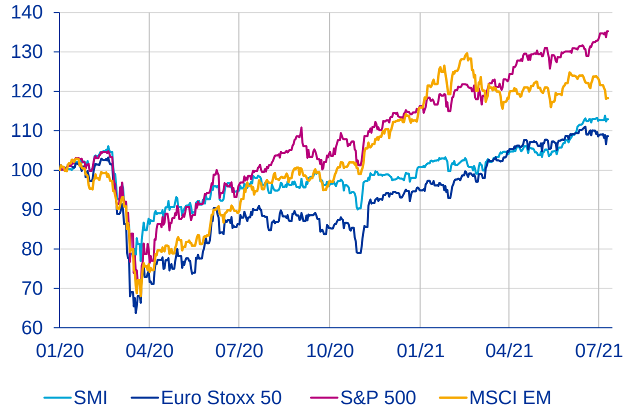
Outlook: Taking into account the planned infrastructure programmes in the USA as well as in Europe, the strong demand for commodities will continue. Consequently, credit spreads should also remain low. We also expect credit spreads for other sectors to move sideways in the second half of the year, both for bonds denominated in euros and in US dollars, and to remain at a very low level. A turn away from the loose monetary policy in Europe is unlikely, as already mentioned, and even a possible premature tapering of bond purchases by the Fed should not cause spreads to rise strongly, as we assume a controlled reduction of bond purchases by the Fed in such a case.

Equities: Less potential in the 2nd half-year

Review: Equity investors were able to look back on a good 1st half-year overall. The global stock market, measured by the MSCI All Country Index, rose by 11.4%. Slightly higher, at 12%, was the performance of the Swiss Market Index. The EuroStoxx 50 and the S&P 500 were particularly strong during this period, each with a performance of just over 14%. In view of the sluggish progress on imports as well as higher US interest rates, the performance for emerging market stocks has been somewhat more subdued in recent months. At the end of June, the MSCI Emerging Markets Index was 6.6% above year-end.

Chart

Equity markets



Sources: Baloise Asset Management, Bloomberg Finance L. P., as of 10.07.2021

Outlook: The low interest rate environment, loose monetary policy as well as the economic reopening argue overall for a positive equity market development, especially in cyclical sectors.

Given the strong rally, the global stock market is now already 25% above its pre-Corona shock peak. The good news is that corporate profits have recovered since the Corona shock. This keeps a further rise in already high valuations in check. Investors and analysts expect the strong corporate earnings performance to continue. This holds the potential for disappointment and leaves little room for positive surprises or strong price increases, especially in regions where economic momentum is already slowing.

We see economic concerns as well as tapering discussions by the Fed as sources of potential volatility on the stock markets in the coming months.

Currencies: Fed reassessment strengthens the US dollar

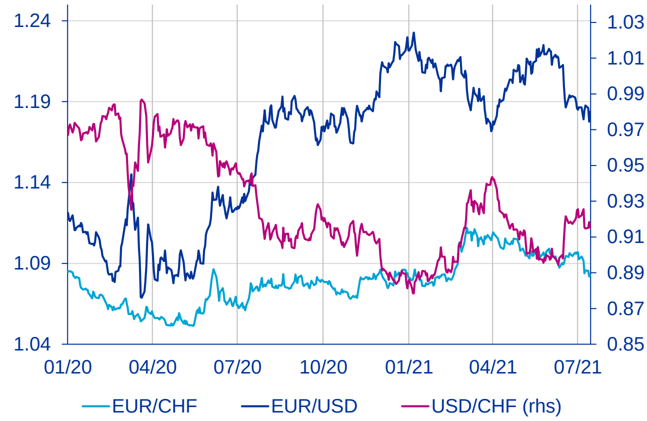
Review: In recent months, the US dollar in particular caused some movement on the FX markets. After a weak start to the second quarter, demand for the greenback rose again in June. The trigger for the turnaround was the Fed's reassessment. At its meeting in mid-June, the central bank announced that two interest rate hikes in 2023 were appropriate. In March, the Fed still signalled that interest rates would remain unchanged until 2023. As a result, the US dollar gained 1.9% against the Swiss franc and 2.2% vis-à-vis the euro within a month.

Outlook: In view of the emerging concerns of an economic slowdown at the beginning of July, investors became somewhat more risk averse and the Swiss franc, as a safe haven, appreciated again somewhat. We consider this strengthening to be temporary. Overall, we therefore assume that the next few months will be characterised by a risk-friendly market environment thanks to the progress of the global vaccination campaigns. This weakens the appreciation pressure on the Swiss franc somewhat and thus the need for the Swiss National Bank to intervene in the foreign exchange market.

As the economic and interest rate outlooks for Switzerland and the euro area are similar, no significant appreciation or depreciation is expected for the EUR/CHF exchange rate. However, the drivers of US dollar strength, i.e. the positive growth and interest rate differential, remain intact and should continue to support the dollar somewhat in the next quarter.

Chart 6

Exchange rates



Sources: Baloise Asset Management, Bloomberg Finance L. P., as of 12.07.2021

Real Estate Switzerland

Review: Due to oversupply, residential rents across Switzerland are around 2.2% below the previous year's level. But despite falling rents, investors still prefer residential investment properties and accept yield compression. Compared to January 2021 at 1.89%, the minimum real discount rate for a new medium-sized residential investment property in a good location in Zurich was again lower in April 2021 at 1.88%. As with residential properties, office properties in A-locations are also particularly sought after.

Within the first semester, the performance of real estate funds according to the SXI Swiss Real Estate Funds Total Return Index was 5.95%. As of 31 May 2021, the average premium of all listed Swiss real estate funds was 38.1% (for comparison, as of 31 December 2020: 40.7% premium). The premium difference between commercial real estate funds and residential real estate funds was around 14 percent at the end of May 2021.

Chart 7

Real estate Switzerland

Sources: Baloise Asset Management, Bloomberg Finance L. P. , as of 12.07.2021

Outlook: Even though the SNB recently raised its inflation forecast for the end of 2021 from 0.6% to 1.0%, the SNB is continuing its expansionary monetary policy and leaving the key interest rate unchanged at -0.75%. The low interest rate environment therefore continues to support the Swiss real estate market.

The progress of the vaccination campaign should continue to drive the recovery of the economy and result in above-average economic growth. Thanks to the very extensive government aid measures, a wave of layoffs and bankruptcies was averted.

The macroeconomic environment is and will therefore remain positive for the Swiss real estate market. However, regional imbalances are likely to persist.

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