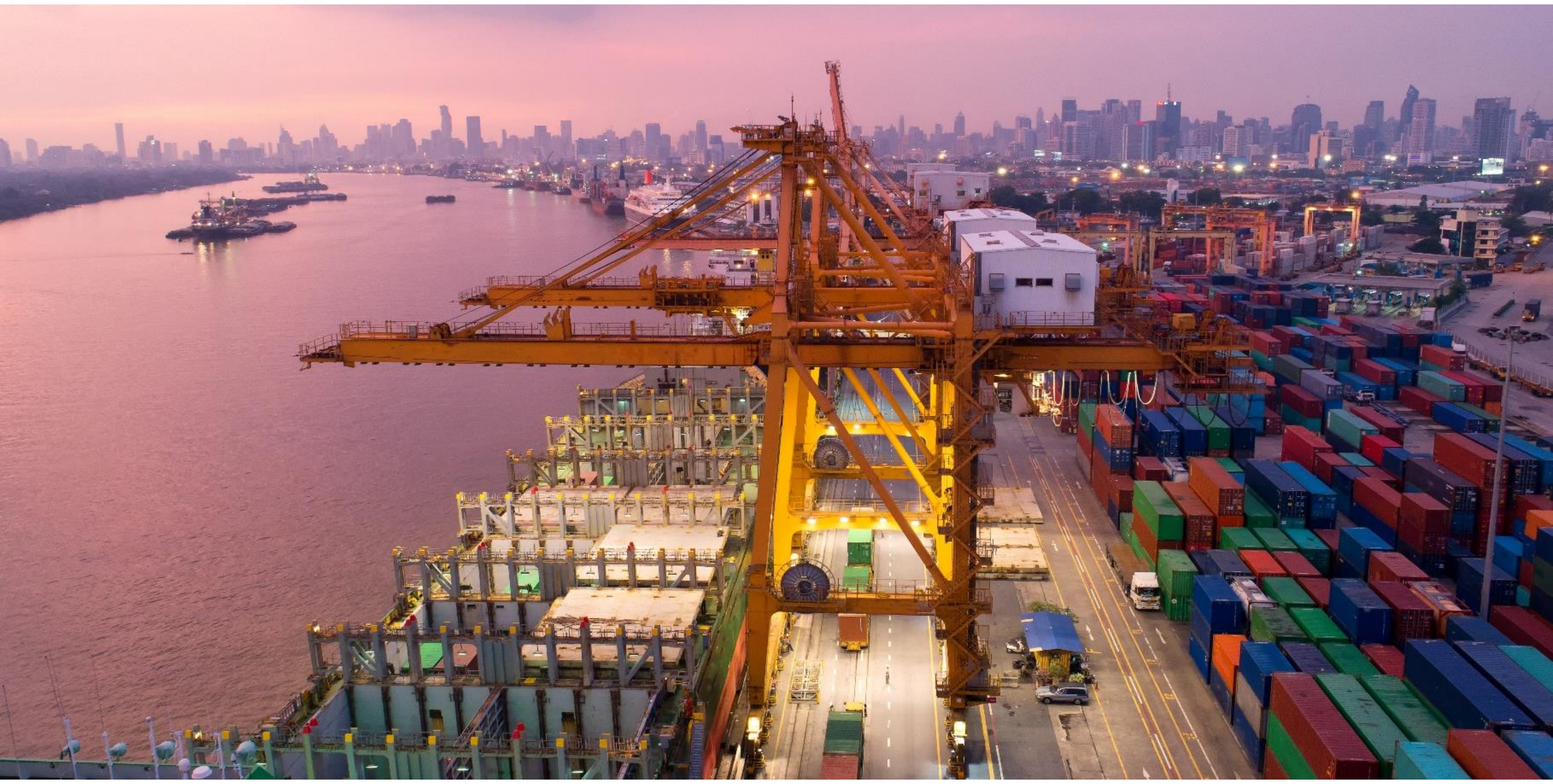
Market Outlook 1st Quarter 2022

The pandemic and supply shortages continue to shape the global economy



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Economic outlook

- The recent Corona wave is dampening global economic growth in the short term. We expect the measures due to Omicron to be less drastic for the economy than in previous waves.
- The persistent material and supply bottlenecks and consequently the rise in inflation rates are likely to continue for the time being. A reversal of this trend is not expected until the second half of the year.

Financial market implications

- Central bank policy is increasingly diverging. While there are interest rate cuts in China, the US Federal Reserve is holding out the prospect of at least three rate hikes.
- The withdrawal of the Fed and gradually also of the ECB should cause some uncertainty. However, the low interest rate environment remains intact in Europe. Equities, corporate bonds, and real estate therefore remain attractive in relative terms, but selectivity is and remains essential.

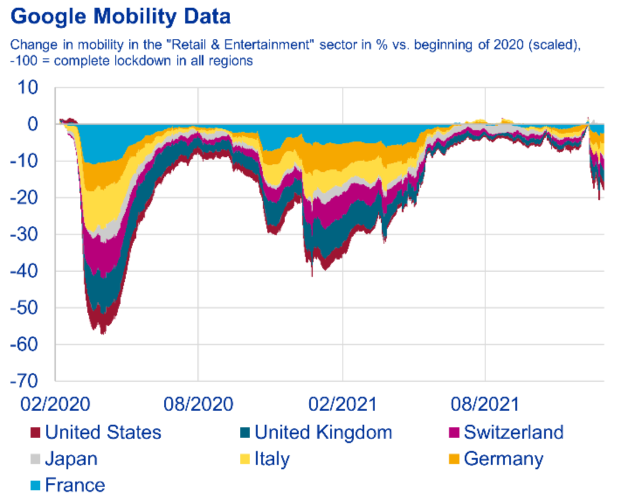
Risks

- Further Corona outbreaks threaten the normalisation of global supply chains and production capacity, which in turn could delay the expected easing in inflation dynamics.
- A potential misstep by central banks, especially in the US and the euro area, would result in significant price corrections on the financial markets.

Global Economy: Still covid driven

While the manufacturing sector has recently improved slightly, the renewed rise in Corona cases is weighing on services. Accordingly, the global Purchasing Managers' Index (PMI) weakened somewhat towards the end of 2021. With a value of 54.9 points the indicator, however, still signals an expansion of the world economy.

Chart 1



Sources: Baloise Asset Management, Bloomberg Finance L.P. , per 15.01.2022

We expect omicron to continue to weigh on the economy in the coming months. But thanks to experience and the vaccination progress, governments, especially in advanced economies, can react with more targeted covid measures, such as regulating access based on vaccination status instead of closures or shortening quarantine periods. Omicron is thus likely to have a less drastic impact on economic activity than previous outbreaks. This is supported by the recent trend in mobility (see chart 1).

However, the recent Covid wave is likely to delay the normalisation of inflation. While we see production capacity continuing to build, in Asia this build-up may be stalled due to China's zero-tolerance policy on COVID-19 cases. As the pandemic situation eases, consumers are likely to increasingly shift their consumption back from goods to services. The imbalance between supply and demand should thus be resolved in the second half of the year and, as a result, inflation will also decline again.

However, this scenario is currently subject to a high degree of uncertainty, as the duration of material and supply bottlenecks is difficult to estimate and varies depending on the product and supply route. In addition, new covid-19 mutations continue to pose a potential risk to the global economy.

Switzerland: Robust economic development despite omicron. Economic indicators have moderated in recent months but continue to point to above-average growth for the first quarter. This optimistic outlook is also reflected in the labour market. Many companies have hired additional workers to cope with the strong demand. The seasonally adjusted unemployment rate at the end of 2021 was with 2.4%, only slightly above its pre-crisis level of 2.3% in February 2020. However, the massive increase in new covid infections in Switzerland clouds the outlook. So far, the measures implemented by the Federal Council are less restrictive than during previous outbreaks. However, the highly contagious mutation could lead to staff shortages in various sectors.

Inflation was 1.5% in December. This is 2.3 percentage points above the previous year's level. A large part of this development is driven by higher energy prices. Inflation excluding fresh and seasonal products, energy and fuel, the so-called core inflation, was a meagre 0.8%. We expect inflation to rise somewhat further in the coming months, but do not believe that the Swiss National Bank's definition of price stability is at risk.

Key Figures, in % to previous year

	2021	2022
GDP growth	3,5 %	3.0 %
Inflation (year-end value)	1,5 %	0,4 %

USA: Wave of layoffs in the US labour market. In November, 3% of American workers, about 4.5 million people, voluntarily quit their jobs, a historic record. The reasons vary. On the one hand, there are pandemic-related motives such as COVID-19 burnouts, lack of childcare options or mandatory vaccination by employers. On the other hand, given the high number of job openings, many Americans also believe they can find a better job. In November, for the nearly 10.6 million job openings there were only 6.8 million job seekers. In such an environment, workers gain bargaining power. This puts upward pressure on wages and thereby on inflation. However, the biggest drivers of inflation can still be attributed to special effects such as the chip shortage, base effects due to energy price developments and the economic reopening.

We expect inflation, as measured by the consumer deflator, to ease but remain above the Fed's long-term target of 2% on average at the end of the year.

The expected interest rate hikes by the central bank are likely to take some of the momentum out of economic growth in the medium term (see section on monetary policy). At the same time, it is difficult for Biden's government to get major spending proposals approved in times of record high inflation. The planned "Build-Back-Better" stimulus package of around USD 2 trillion is therefore likely to be cut.

Key Figures, in % to previous year

	2021	2022
GDP growth	5,6 %	3,8 %
Inflation* (year-end value)	5,5 %	2,7 %

* Measured at the consumption deflator.

Euro area: Cooling of the service sector. Rising covid cases are constraining growth in the euro area. Although the Purchasing Managers' Index for the monetary union continues to point to economic expansion, it fell to a nine-month low in December. The service sector in particular is suffering from the tougher containment measures. Meanwhile, manufacturing continues to struggle with shortages and high purchase prices. At the country level, the picture is mixed. While the composite index for Germany fell below the 50 mark and reached an 18-month low, the situation in France is much more robust with a PMI of 55.8 points.

The overall unemployment rate continued to fall and at 7.2 % in November was only 0.1 percentage points above the pre-crisis level of March 2020. As bottlenecks and the epidemiological situation ease, the EU economy should continue to pick up speed over the course of the year.

Inflation reached 5% in December. However, about half of this increase is due to energy price developments. In the current quarter, too, rates are expected to remain above average before falling again thereafter.

Key Figures, in % to previous year

	2021	2022
GDP growth	5,1 %	4,2 %
Inflation (year-end value)	5,0 %	1,3 %

China: The economy is losing steam. Economic growth in the fourth quarter of 2021 was stronger than expected at 4.0 % compared to the previous year (3.3 %). China's economy benefited from buoyant global demand. Export growth was a robust 21 % in December 2021. However, the collapse of the real estate sector, which accounts for almost 30% of China's GDP including related services, will continue to weigh on the economy. The Chinese central bank has therefore recently lowered key interest rates and increased the supply of credit. A looser monetary policy is intended to slow down the growth slowdown.

After a series of power outages forced factories in various regions of China to temporarily curtail production last quarter, the spread of Omicron is now threatening production and export capacity. With the Olympic Games coming up in February, the authorities are unlikely to budge on their zero-covid strategy.

Rising raw material prices as well as high freight and shipping costs have pushed producer prices up sharply. They are currently 10.3% higher than in the previous year. However, this increase has hardly been passed on to consumers. Thus, consumer price inflation was only 1.5% in December.

Key Figures, in % to previous year

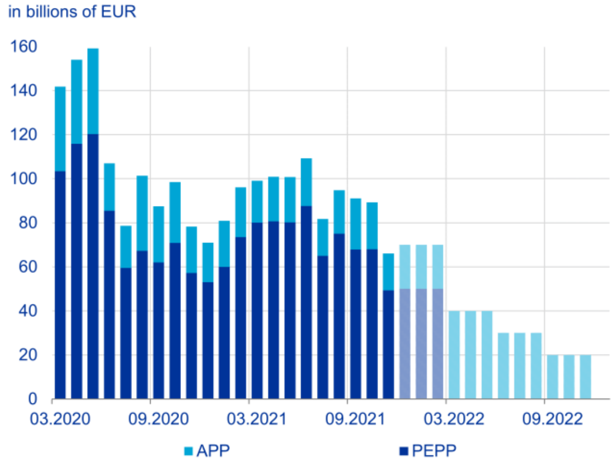
	2021	2022
GDP growth	8,1 %	5,2 %
Inflation (year-end value)	1,5 %	2,4 %

Monetary policy: a reassessment

In December, the **US Federal Reserve** (Fed) admitted that inflation was more persistent than it had originally assumed. It therefore accelerated the tapering of the quantitative easing (QE) programme. This is to be discontinued in March. The first interest rate hike is likely to follow shortly thereafter. The Fed signalled three rate hikes for 2022 at the end of 2021, and the latest inflation and labour market data support this new direction. In the last rate hike cycle, the Fed waited almost two years after the first rate hike, before winding down its balance sheet. The reduction of the balance sheet is likely to start much earlier in this cycle, and at best even this year.

Graph 2

Eurozone: Monthly PEPP and APP purchases



Sources: Baloise Asset Management, Bloomberg Finance L.P. , per 15.01.2022

There is also a slight tightening of monetary policy in the euro area, albeit less pronounced than in the USA. The **European Central Bank**'s (ECB) emergency purchase programme (PEPP) introduced during the pandemic is scheduled to end by the end of March. However, the ECB will remain active in the bond market beyond March 2022 with its long-term bond purchase programme, APP. In fact, after the end of PEPP, purchases under the APP programme are to be increased from EUR 20 billion to EUR 40 billion per month and then gradually reduced again in the following quarters. The aim is to withdraw liquidity only gradually from the market. A maximum duration for this programme has not been announced. It is to be continued until shortly before a rise in key interest rates (see chart 2).

Due to the strength of the Swiss franc, the inflation trend in Switzerland remains subdued by international standards. The latest estimates of the **Swiss National Bank** (SNB) also show that inflation, after a moderate increase in the next few months, will fall below the 1% mark again and remain there until 2024. This is even assuming that the policy rate remains at -0,75 %. There is therefore no departure from the SNB's ultra-loose monetary policy in sight.

Central banks, such as the Fed, have put interest rate hikes on the horizon for the next few months. However, even though the risk Omicron poses to the global economy has diminished significantly in recent weeks, a rapid spread in January and February 2022 is considered inevitable. This carries the risk of at least delaying the economic recovery. At the same time, there is strong uncertainty surrounding the inflation outlook. Monetary policy is therefore becoming a tricky balancing act for central banks. Tightening policy rates too quickly could stifle economic growth. If policy is too lax, there is a danger that inflation will no longer be under control. A misstep in this regard would accordingly result in a significant market sell-off.

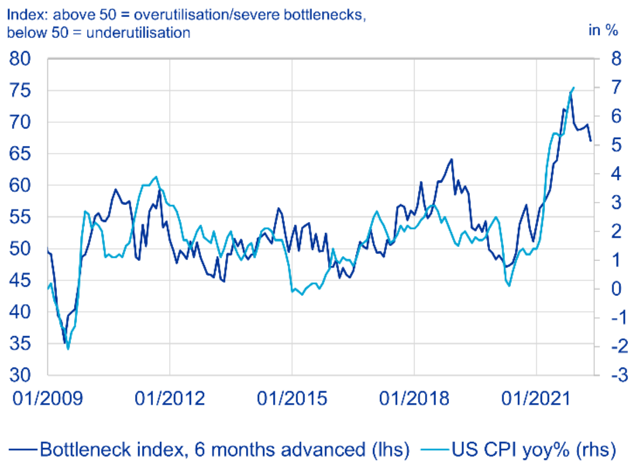
Focus: End of supply bottlenecks in sight?

Inflation rates recently reached record levels. One reason for this is that demand exceeded production capacity amid the economic reopening last year. This resulted in material and supply bottlenecks. For businesses and consumers, this means rising prices and longer waiting times.

Signs of improvement can be seen at least in the USA. According to company surveys, delivery times are shortening and price increases for intermediate products are also gradually decreasing, albeit from a very high level. In addition, order backlogs in the US have also been easing since mid-2021. The bottleneck in US manufacturing thus seems to have peaked for the time being and should exert less pressure on consumer price inflation in the coming months (see chart 3).

Chart 3

USA: Manufacturing bottlenecks easing



*Average of purchasing managers' sub-indices for delivery times and order backlogs
Source: Baloise Asset Management, ISM, Bloomberg Finance L.P., as at 15.01.2022

In our baseline scenario we assume that the bottlenecks in global trade will ease somewhat towards the second half of the year. However, closed ports and missing containers in the aftermath of the Corona pandemic continue to threaten the normalisation of supply chains and thus inflation. The recent omicron outbreak in China poses a significant risk of further delay, given the zero-tolerance policy there.

Bonds: Flat yield curves

Review: The fourth quarter was characterised by high inflation, flattening yield curves, the new Corona variant and low credit spreads. The strong flattening of the yield curves was particularly striking. Heightened inflation caused interest rates at the short end of the curve to rise sharply. At the same time, the more hawkish monetary policy that has been introduced is having a dampening effect on long-term economic expectations, which is pushing interest rates down at the long end of the curves.

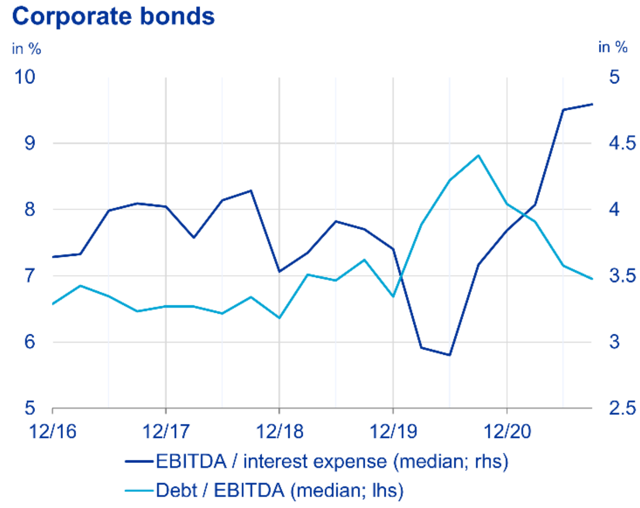
The curve for US government bonds flattened by a whopping 46 basis points (bp) between the 5-year and 30-year maturities, caused by a 34 bp increase in yields on 5-year government bonds and a 13 bp decrease in yields on 30-year Treasuries. For German government bonds, the flattening was somewhat less pronounced, but also significant at -18 bp over the same period.

Credit spreads remained at historically low levels in the last quarter of the year. With the emergence of Omicron, there was a short-term widening of risk premiums in November. However, this trend did not continue in December. More and more studies proved that the new virus variant was more contagious than the previous ones, but that the course of the disease was much milder, which is why public life should not be affected as much as originally feared. The risk premiums therefore fell again somewhat and remain at an extremely low level.

Outlook: There are no interest rate hikes on the ECB's agenda for 2022 (see section on monetary policy). In our view, however, the interest rate on the 10-year German Bund should jump back into positive territory just above zero.

Regarding credit spreads, we do not expect them to move back to the pre-Omicron lows in the medium term as the economic recovery is likely to be delayed by the current covid resurgence.

Chart 4



Benchmark Index: Bloomberg Global Aggregate - Corporate
Sources: Baloise Asset Management, Bloomberg Finance L.P., per 15.01.2022

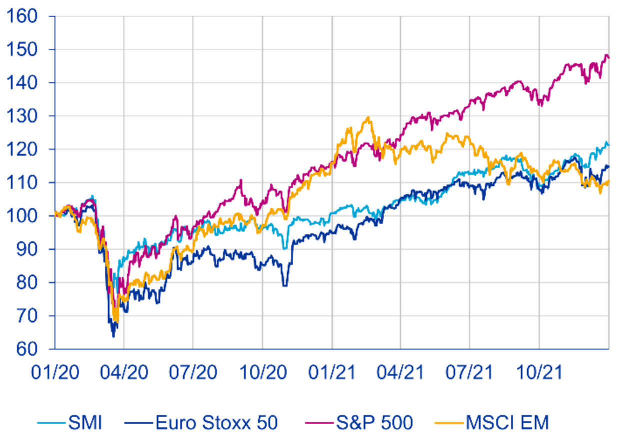
The second-round effects triggered by the persistently high level of inflation could put additional pressure on companies' margins, especially in the USA. Here it is crucial whether companies operate in a competitive environment that allows them to pass on cost increases and wage rises to their customers. However, corporate fundamentals have recovered strongly over the past year (see chart 4). This, together with rising vaccination rates and new treatments for severe courses of covid-19, leads us to expect credit spreads to move sideways in the coming months.

Equities: More challenging environment

Review: 2021 was a great year for equity investors despite the rise in inflation. In most regions, investors saw a performance in the double digits (see chart 5). The SMI, for example, rose by 23% and the S&P 500 by as much as 31%. On average, global equities, as measured by the MSCI World Index, rose by around 20%. The big exception were emerging market stocks: the MSCI Emerging Markets Index declined by 4.25%. Lower vaccination rates, higher interest rates and China's real estate crisis were the driving forces behind this.

Chart 5

Equity Markets



Sources: Baloise Asset Management, Bloomberg Finance L.P., per 15.01.2022

Outlook: The economy will be dampened in the short term by the recent Corona wave. However, we expect the above-average economic growth to resume thereafter. This will continue to support corporate earnings. Analysts therefore expect earnings growth for 2022 in Europe and North America to be higher than the average of the last 10 years.

Overall, we expect interest rates to rise slightly. Especially in Europe, however, the low interest rate environment remains intact in a historical context. In principle, this continues to speak in favour of equities. At the same time, however, the withdrawal of central bank liquidity is also weighing on the equity markets.

High inflation is also a risk for the stock markets. Rising costs squeeze margins and thus profits if companies cannot pass them on to their consumers. The focus should therefore be on companies with strong pricing power and innovative product lines.

Currencies: US dollar strength thanks to monetary policy

Review: The US dollar gained 6.4% in 2021 on a trade-weighted basis. Thus, as of the end of December, the greenback stood at CHF and 0,9129 there were USD per euro 1,1370 (see chart 6). An important driver of this development was that the Fed pursues a more interest rate policy than the central banks in the EU and Switzerland (see section on monetary policy).

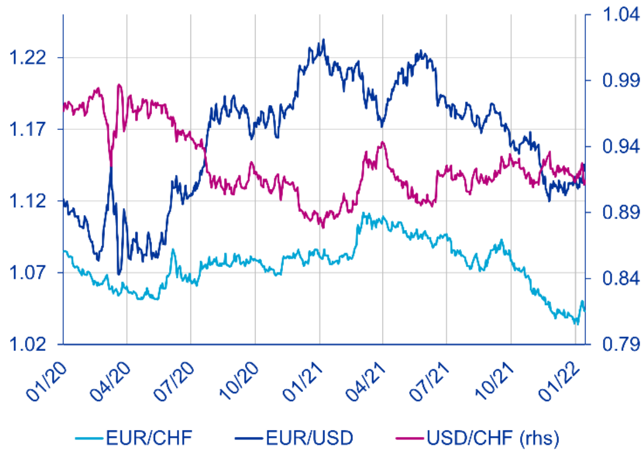
In the same period, the Swiss franc gained around 4% against the euro. This was particularly the case in times of heightened uncertainty in the market, such as the breakout of Omicron in November 2021. During such periods, investors look for safe haven assets, such as the Swiss franc. The euro thus fell below the CHF 1.04 mark at the end of December. The last time the euro was this low against the franc was shortly after the end of the minimum exchange rate in 2015.

Outlook: Amid an easing of the Corona situation, a stronger euro against the Swiss franc can generally be expected again. However, the presidential elections in France are likely to cause further uncertainty in the euro area in March and April. The euro could therefore come under some pressure again. If the upward pressure on the Swiss franc is too strong, the SNB is likely to become more active in the foreign exchange market.

Regarding the US dollar, we assume that the favourable interest rate differential with the euro area and Switzerland should support the greenback in the coming months.

Chart 6

Key Currencies



Sources: Baloise Asset Management, Bloomberg Finance L.P., per 14.01.2022

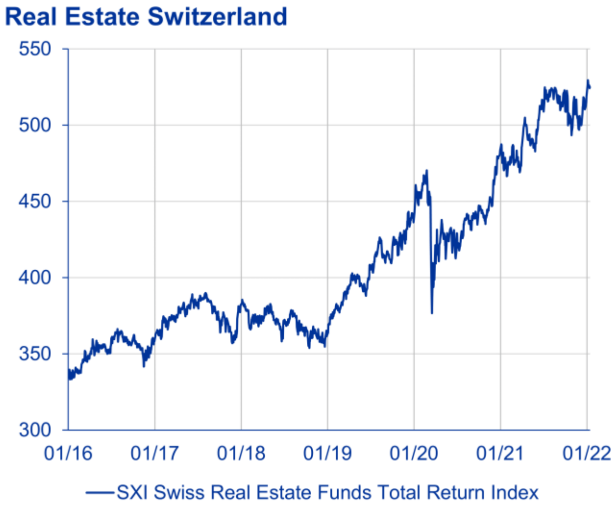
Real Estate Switzerland

Review: Swiss real estate funds, measured by the SXI Swiss Real Estate Funds Total Return Index, performed significantly better in 2021 (7.32%) than real estate shares, measured by the SXI Swiss Real Estate Shares Total Return Index (4.16%).

The Swiss low interest rate environment continues, which has a positive effect on the real estate market. As in the previous quarter, inflation dynamics are not yet a cause for concern, unlike in other countries (see section on monetary policy). Real estate investments are therefore still attractive compared to government bonds.

On the buyer side, however, lower yields are to be expected. Compared to August 2021, the minimum discount rate for multi-family houses in prime locations fell by a further 2 basis points to 1.79% in October 2021.

Chart 7



Sources: Baloise Asset Management, Bloomberg Finance L.P. , per 14.01.2022

Outlook: In the Swiss rental housing market, the number of vacant flats declined in 2021 for the first time since 2008. In absolute terms, however, the vacancy level remains high. New rents continued to fall in the third quarter of 2021 (-0.28%). Project developers are therefore continuing to reduce new residential construction. The soft landing of the Swiss rental housing market is therefore expected to continue.

In response to the reduced long-term demand forecast for office space, building applications for office buildings in 2021 are around 19% below the long-term average.

In the medium to long term, further difficulties in the retail space market are to be expected in the periphery, even if vacancies declined slightly during 2021. The gastronomy sector continues to be the most affected by the COVID 19 pandemic. After the expiry of government support measures, property price declines are therefore likely in this segment.

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