Market Outlook Third Quarter 2022

The end of ultra-loose monetary policy

Market Outlook Third Quarter 2022

The end of ultra-loose monetary policy

Economic outlook

- Inflation remains stubbornly high. To contain it, central banks must tighten their reins noticeably.
- Economic growth is likely to decline significantly as a result.

Financial markets

- An immediate turnaround in the financial markets is not expected. This means continued upward pressure on interest rates and declining stock markets.
- Rising interest rates reduce the relative attractiveness of real estate funds.

Risks

- Too aggressive rate hikes by central banks risks choking off economic growth.
- 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 easing of inflation dynamics.
- At the same time, a strong recovery in China could reignite demand for commodities and thus push up energy and food prices further.
- A further escalation of the war in Ukraine would be highly inflationary and negative for growth.

World economy: Stagflation risks

The rising cost of living, tighter financing conditions, and geopolitical uncertainty are clouding the economic growth outlook. Surveys in the US and Europe show a significant slump in consumer sentiment. Households are therefore increasingly avoiding major investments. Statements from companies also point to a less constructive environment in the coming months.

Chart 1
Development of consensus forecasts

in %. / in %

—Global inflation 2022 (left-hand scale)
—Global GDP growth 2022 (right-hand scale)

Source : Baloise Asset Management, Bloomberg Finance L.P. , as at 04.07.2022

Inflation, on the other hand, remains stubbornly high. The development in the coming months is strongly dependent on energy and food prices. Currently, futures prices as well as analysts' forecasts point to a decline in oil prices towards the end of the year. In this case, inflation should ease slightly in the second half of the year. However, this outlook comes with considerable uncertainty.

The consequences for the global economy are lower growth, with an increasing risk of recession and higher inflation. Accordingly, growth and inflation forecasts for 2022 have been continuously revised (chart 1).

Switzerland: Clouds on the horizon. The Swiss economy was able to increase production capacities in the manufacturing sector in recent months thanks to a brisk increase in personnel. As a result, the seasonally adjusted unemployment rate at the end of June was 2.2%, the lowest in the last 20 years. However, rising purchase prices and the weakening of foreign demand are weighing on industry.

In June, inflation was 3.4% and thus above the target range of the Swiss National Bank. 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 1.9%. However, we expect inflation to rise somewhat further in the coming months.

USA: Rising pessimism. Manufacturing continues to be driven by robust demand, while supply bottlenecks are holding back. However, the latest data point to a weakening of demand. This is also evident in US household spending. It rose by a seasonally adjusted 0.2% in May from the previous month, the slowest pace so far this year, with spending on goods falling by 0.7%. Adjusted for inflation, total spending fell by 0.4% and

spending on goods by 1.6%. This trend is expected to continue in the coming months. Surveys by the University of Michigan show that in the last 44 years Americans have never been as pessimistic about the economic situation as they were in June this year. Inflation and rising interest rates are thus overshadowing the strong labour market, where the unemployment rate is close to an all-time low.

The Federal Reserve's preferred inflation measure, the consumption deflator, is 6.3%. Excluding food and energy prices, inflation has been falling since February and currently stands at 4.7%. We expect headline inflation to rise further in the second half of the year 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.

Euro area: Energy supply takes centre stage. In June, industrial production contracted for the first time since the height of the Corona crisis two years ago. The reason for this is a decline in orders among industrial companies. In the coming months, moreover, uncertainty about energy supply is likely to cloud the situation for industry even further. Within the euro area, Germany, Hungary, and Poland are the most dependent on energy from Russia. Before the escalation in Ukraine, Germany purchased more than 65% of its natural gas from Russia.

The mood among households is also unfavourable. Consumer confidence is at its lowest level since March 2020, even though the unemployment rate remains at an all-time low of 6.6%. However, wage growth of 3.3% in the first quarter cannot keep pace with the rising cost of living.

Inflation reached 8.6% in June. Energy and food price developments continue to be a significant driver. Excluding this, inflation fell slightly in June, but remains stubbornly high at 3.7%. In view of the geopolitical situation and its consequences for commodity markets, further price increases for energy and food are likely to push up inflation rates in the euro area somewhat further in the coming months.

China: On the road to recovery. The strict lockdowns due to China's zero-covid policy had weighed heavily on the economy in recent months. In June, however, the strongest industrial production growth since November 2020 was recorded thanks to the easing of restrictions. In private consumption, on the other hand, the traces of the Corona strategy are likely to be visible for longer. A survey by the Chinese central bank shows that concerns about future income are making consumers increasingly cautious. More than 58% of respondents would rather save their money than spend or invest it. This is the highest share since the survey began 20 years ago.

Producer price inflation was 6.4% in May, more than halving since its peak in October 2021. Consumer price inflation, on the other hand, has risen in recent months. Unlike in many other regions of the world, however, the rate of 2.1% is still below the Chinese central bank's inflation target of 3%.

Figures at a glance, in% compared to previous year

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

*Year-end value, **Measured by the consumption deflator.
Source : Baloise Asset Management, Bloomberg Finance L.P. ; 04.07.2022

Monetary policy: The end of negative interest rates in Europe

The central banks have increasingly shown in recent weeks that fighting inflation is at the centre of their policy, even if this means a significant slowdown in economic growth. Key interest rates are therefore likely to be raised again significantly in the third quarter. Investors are currently assuming that the rise in interest rates will be strongest in the Anglo-Saxon regions (see chart 2).

The **US Federal Reserve** (Fed) raised the key interest rate by 150 basis points between March and June to a range of 1.50% to 1.75%. At the same time, the Fed began to reduce its balance sheet by USD 47.5 billion per month in June. Starting in September, the reduction is to be doubled to USD 95 billion per month. The key interest rates are also to be raised further. For the time being, the Fed is signalling a policy rate of 3.35% for the end of the year, which is in line with to current market expectations.

Chart 2

Rising policy rates

Cumulative changes in policy rates in basis points

Expectation of market participants* for end-2022

400, 350, 300, 250, 200, 150, 100, 50, 0

12.2021, 03.2022, 06.2022, 09.2022, 12.2022

United States, Australia, Canada, Eurozone, Switzerland, United Kingdom

*based on futures, path to year-end is linearly interpolated and does not necessarily correspond to the expected path on a month on month basis

Source: Baloise Asset Management, Bloomberg Finance L.P. , as at 04.07.2022

The **European Central Bank** (ECB) is still somewhat hesitant but announced the first interest rate hike for July and the end of the seven-year bond-buying programme. As a result, yields on EU government bonds climbed. In Italy, however, they rose disproportionately. For example, the yield premium of Italian to German government bonds was over 240 basis points at the levels of spring 2020. In the future, the ECB wants to prevent large interest rate differential in the euro area by means of a new instrument and greater flexibility in reinvesting the maturing bonds on the balance sheet.

In mid-June, the **Swiss National Bank** (SNB) signalled of independence. Market participants assumed that the SNB would not raise interest rates before the ECB. However, to curb inflationary pressures, the SNB raised the key interest rate for the first time in 15 years, by 50 basis points to -0.25%. Further rate hikes are also expected. The SNB also spoke for the first time of a possible sale of foreign currency - a clear turnaround in Swiss monetary policy.

We expect to see the end of the negative interest rate policy on the part of the ECB and the SNB by the end of the year at the latest.

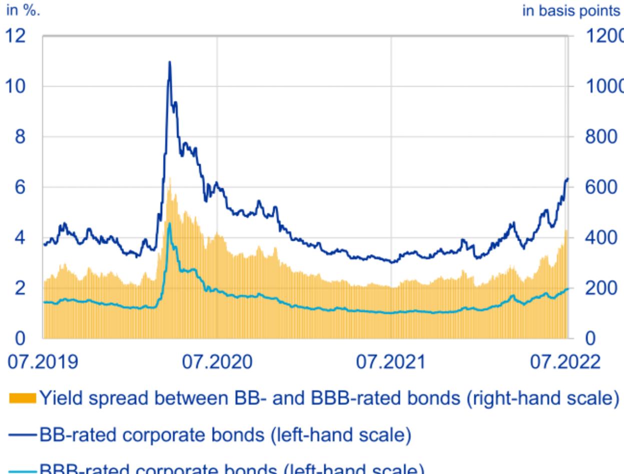
Bonds: Rising interest rates

Review: The global economy continues to face major challenges. This is reflected in the development of credit spreads, which have widened significantly since the second quarter. What is striking here is the divergence between the credit premiums of corporate bonds in the high yield segment and those in the investment grade segment, an indicator of an increasingly uncertain market environment (see chart 3).

Inflation has remained at very high levels since the beginning of the year, which is why the central banks have announced (ECB) or initiated (Fed) a significantly more restrictive monetary policy course (see section "Monetary policy"). Higher interest rates mean higher refinancing costs for companies. This, in combination with the ongoing problems in global supply chains, higher energy costs and rising wage pressure (especially in the USA), is putting pressure on companies' margins and essentially explains the rise in credit spreads.

Chart 3

Global credit spreads



Sources: Baloise Asset Management, Bloomberg Finance L.P., as at 04.07.2022

Outlook: In our opinion, inflation will remain at an elevated level in the medium term. In Europe, this is mainly due to high energy and food prices. There are no signs that the war in Ukraine will end soon. Given Europe's dependence on Russian gas, we expect energy prices to remain high in the second half of the year. We also expect US inflation to remain high. Second-round effects, such as rising wage costs, will have a lasting impact on the inflation rate. Against this background, we expect interest rates to continue to rise.

We see little potential for a strong tightening of credit spreads in the coming months. A return to historical lows such as those seen in mid-2021 unlikely. Less intervention by central banks as well as rising interest rates and the associated higher refinancing costs for companies limit the potential for tightening spreads. For companies with a cyclical business profile and/or tight financial profile (low margins, high leverage), there is also the possibility of seeing even higher credit spreads by the end of the year.

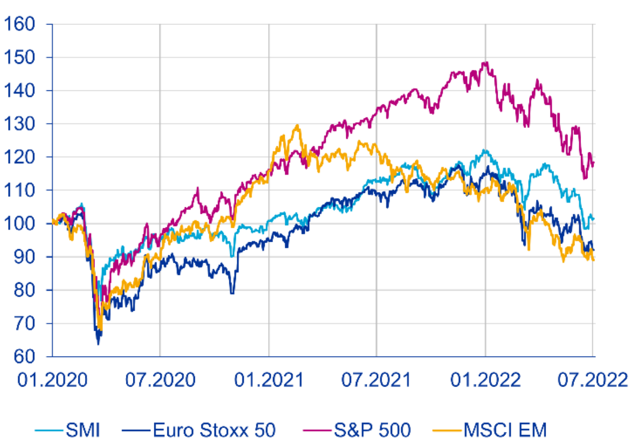
Equities: The bear market is back

Review: The Ukraine war, inflation fears, and the interest rate turnaround led to losses in equities. Various stock markets fell more than 20% from their previous highs and are thus currently trading in a bear market. In terms of sectors, communication services and cyclical consumer goods were the biggest losers. Only the global energy sector, which benefited from rising commodity prices, posted a gain of over 20% in the first six months of the year.

At the end of the first half of the year, the performance of the EuroStoxx 50 was -19.6% and that of the S&P 500 -20.6%. The losses of the more defensive Swiss Market Index were somewhat less severe at -16.6%.

Chart 4

Equity Markets



Sources: Baloise Asset Management, Bloomberg Finance L.P., as at 04.07.2022

Outlook: The outlook for the third quarter is subdued. High inflation and rising interest rates are likely to continue to have a negative impact on the market environment in the coming months.

In addition, the fears of recession that have arisen are increasingly unsettling investors. In the last century, 7 out of 10 bear markets in the US went hand in hand with a recession. If we take the past as a yardstick, the current correction phase could well last even longer. On average, the bear market phase of the S&P 500 lasted 20 months with an average loss of 41%. Since much negativity has already been anticipated in current prices, we do not currently expect to see such a sharp decline. However, the current downward trend is likely to continue in the third quarter, albeit with short-lived rebounds.

While share prices have already fallen sharply, corporate earnings and their estimates still look relatively robust. However, we expect weak consumer sentiment and persistently high input costs to weigh on margins and earnings growth. Companies without strong pricing power are most exposed in this environment. A correction in earnings is therefore to be expected, which is why we currently assess the risk-reward profile for equities as rather unattractive.

Currencies: All about interest rate differentials

Review: There were also significant price fluctuations on the foreign exchange market in the first half of the year. While the war in Ukraine dominated the market environment towards the end of the first quarter, the focus in recent months has been on the central banks' policy tightening. The Fed's tighter interest rate policy caused the US dollar to appreciate by more than 7% in the first half of the year in trade-weighted terms. At the end of June, the greenback stood at CHF 0.9551 and USD 1.0484 per euro.

The Swiss franc, which was still benefiting from its role as a safe haven at the beginning of March, depreciated by over 4.5% against the euro in the following months. When the SNB surprised investors with its aggressive interest rate hike in June, the trend reversed (see section "Monetary policy"). Thus, the euro briefly fell below parity. At the half-year point, the EUR/CHF rate was at 1.0011, which means an appreciation of the Swiss franc of 3.5% since the beginning of the year.

Outlook: We assume that the SNB will no longer intervene strongly in the foreign exchange market in the next quarter. The first indication of this is the declining sight deposits at the SNB since May. In addition, certain fair value models now indicate that the fair value of the euro to the Swiss franc is below parity. It is therefore no longer possible to speak of a strongly overvalued franc, which the SNB would have to weaken. Consequently, this means that the current strength of the franc is likely to continue in the third quarter.

Chart 5

Development currencies

1.23 | 1.18 | 1.13 | 1.08 | 1.03 | 0.98 (lhs); 1.04 | 0.99 | 0.94 | 0.89 | 0.84 | 0.79 (rhs)

01.2020 | 07.2020 | 01.2021 | 07.2021 | 01.2022 | 07.2022

EUR/CHF — EUR/USD — USD/CHF (rhs)

Sources: Baloise Asset Management, Bloomberg Finance L.P., as at 04.07.2022

Regarding the US dollar, we continue to assume that the advantageous US interest rate differential, thanks to a more aggressive US Federal Reserve compared to the ECB and SNB, should support the greenback in the coming months.

Swiss Real Estate

Review: The financial market reacted very quickly to the surprising interest rate hike by the Swiss National Bank (see section "Monetary policy"). The performance of real estate funds according to the SXI Swiss Real Estate Funds Total Return Index was -11.2% in the second quarter. The agios of the listed real estate funds decreased by 17.74 percentage points from 34.75% to 17.01% in this quarter. The number of funds with a discount has also jumped, from 5 at the end of March to 12 at the end of June. The changes in the direct real estate market are currently less visible.

Chart 6

Sources: Baloise Asset Management, Bloomberg Finance L.P. , as at 04.07.2022

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 will increase the pressure on property prices. Since real estate cannot be traded as liquidly, the market change will probably only become visible after a while.

The rental housing market is currently still developing quite robustly. This is due to immigration, which, according to data from the State Secretariat for Migration (SEM), was significantly above the previous year's figures in the first quarter of 2022, as well as in April and May 2022. On the supply side, a shortage is more likely. The material costs for construction projects have recently risen significantly and the changes in the interest rate landscape mean that a higher return must be achieved with construction projects so that their realisation becomes financially attractive. Both points tend to lead to fewer realised building projects. In addition, the requirements for new buildings are also increasing and delaying or even preventing new construction projects (e.g. noise protection in the city of Zurich).

Editorial

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

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

Dominik Sacherer
Portfolio Manager Fixed Income
dominik.sacherer@baloise.com

Jan Hagen
Portfolio Manager Real Estate
jan.hagen@baloise.com

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

Appearance
Four times a year, editorial deadline: 08.07.2022

Disclaimer
Baloise Asset Management AG assumes no liability for the key figures and performance data used. The content of this publication contains opinions on market developments and is intended solely for information purposes and not as investment advice. In particular, the information in no way constitutes a purchase offer, an investment recommendation or an aid to decision-making in legal, tax, economic or other matters. No liability is assumed for losses or lost profits that may arise from the use of the information.
SIX Swiss Exchange Ltd (SIX Swiss Exchange) is the source of the Swiss Market Index (SMI) and the data contained therein. SIX Swiss Exchange was not involved in any way in the preparation of the information contained in this report. SIX Swiss Exchange makes no warranty of any kind and disclaims all liability (whether in negligence or otherwise) with regard to the information contained in this Reporting - including, without limitation, the accuracy, adequacy, correctness, completeness, timeliness and suitability for any purpose - and with regard to errors , omissions or interruptions in the SMI or its data. Any dissemination or transmission of the information originating from SIX Swiss Exchange is prohibited .