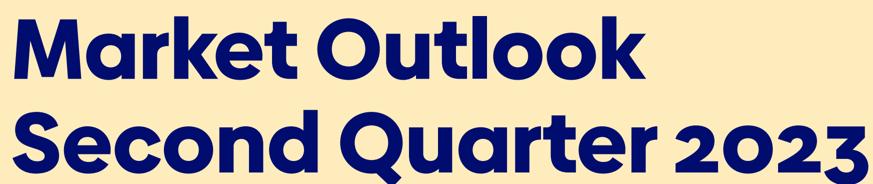

Market Outlook Second Quarter 2023

First cracks are starting to show

Market Outlook Second Quarter 2023
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Economy
- Inflation rates are declining, but core inflation, is likely to remain higher than desired.
- A recession in Europe was avoided for now, but the shrinking purchasing power of consumers and the high financing costs for companies are likely to weigh on growth.

Financial markets
- We expect the banking turmoil to be contained, but caution is advised.
- Selectivity and diversification are therefore crucial. Companies with little pricing power and high financing needs are under the most pressure. We prefer defensive sectors.

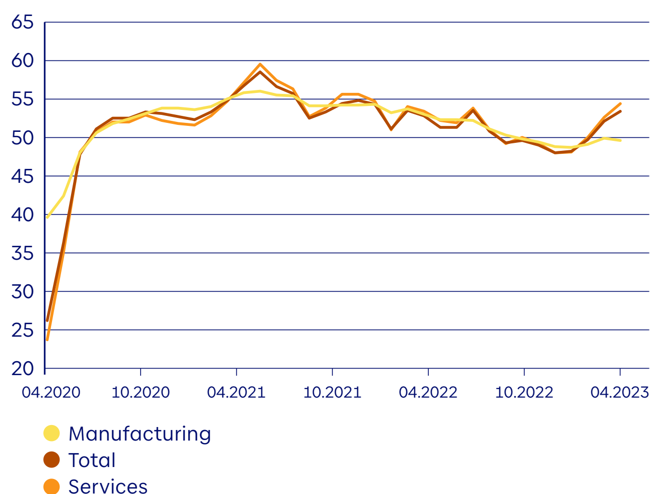
Risks
- An escalation of the banking crisis would cause stock market prices and interest rates to fall sharply, while credit spreads on bonds would widen significantly.
- Geopolitical risks are practically incalculable. A further escalation of the war in Ukraine would be highly inflationary and, at the same time, growth-inhibiting.

Economy: Recession avoided for now

Economic growth has surprised to the upside in recent months. However, expectations were low at the same time. Many analysts expected the euro area to fall into recession as early as the end of 2022 due to the energy crisis. Thanks to a mild winter, alternative energy sources and a reduction in consumption, the energy bottleneck was handled better than expected.

Slight economic recovery

Global purchasing managers' indices; above 50 = economic upswing, below 50 = economic slowdown



Sources: Baloise, Bloomberg Finance L.P. S&P Global, as of 03.04.2023

Leading economic indicators, such as the global purchasing managers' index, which stood at 53.4 points in March, point to an improvement in the economic growth. However, a strong upswing is not to be expected.

Shrinking purchasing power due to high inflation is set to weigh on demand in the medium term. At the same time, households and businesses are facing significantly higher financing costs than in recent years.

Inflation

We expect inflation to continue to decline over the year. But even at the end of 2023, inflation is likely to still be above the central banks' targets in many places. The following four factors support this view:

- Compared to last year, gas and oil prices in Europe have now fallen by 66% and 34%, respectively. This is having a positive impact on headline inflation. Spain's inflation, for example, halved to 3.1% in March. However, the core rate, excluding food and energy prices, remains stubbornly high at 7.5%. The year-on-year drop in **energy prices** should still have a positive impact on inflation in April. Starting in May, the oil cartel OEPC+ plans to cut oil production by more than 1 million barrels per day. This might heighten price pressures somewhat.
- **Material and supply bottlenecks** have already eased significantly. The end of China's zero-covid policy should further support the recovery.
- **Interest rate hikes are starting to take effect.** Monetary policy has a delayed impact on the economy and thus on inflation. Studies show that it takes 12 to 18 months after a policy rate hike for the maximum decline in prices to become apparent.
- **Historically low unemployment rates** in Europe and the US are supporting wage growth and thus inflation, especially in services. The US labor market in particular is incredibly tight. In January, there were more than 5 million more vacancies than job seekers.

Forecast uncertainty regarding inflation developments remains high. A geopolitical escalation could push commodity prices and thus inflation up again, while an escalation of the banking crisis would have a deflationary effect.

In conclusion, weak growth overall and still elevated inflation are to be expected for 2023.

Figures at a glance, in percent compared to previous year

		2022	2023
Switzerland	GDP growth	2.2 %	0.6 %
	Inflation*	2.8 %	2.2 %
USA	GDP growth	2.1 %	1.0 %
	Inflation**	4.6 %	3.4 %
Eurozone	GDP growth	3.5 %	0.5 %
	Inflation*	9.2 %	3.1 %
China	GDP growth	3.0 %	5.3 %
	Inflation*	1.8 %	2.7 %

*Year-end value. **Measured at the consumption deflator.

Sources: Baloise, Bloomberg Finance L.P., as at 03.04.2023

Banking crisis: The consequences of the interest rate turnaround

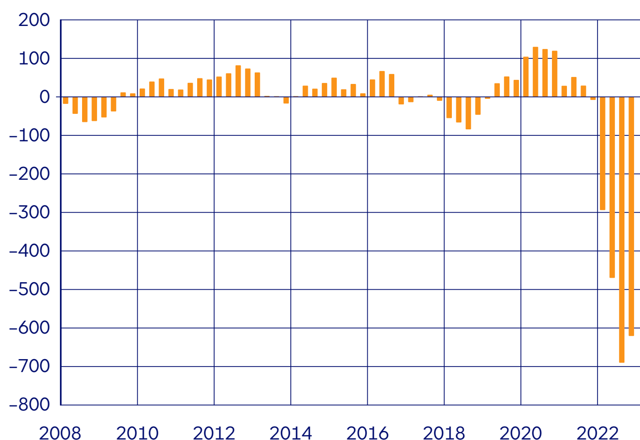
The rapid and strong rise in interest rates has negative consequences. The collapse of Silicon Valley Bank (SVB) and other US regional banks at the beginning of March is one such. Fears of a large-scale banking crisis spread. As a result, global bank shares lost 16 % of their value within two and a half weeks.

One implications of the sharp rise in interest rates last year is that banks have large unrealised losses on their books. For US banks, these amounted to over USD 620 billion at the end of 2022 (see chart). This becomes problematic when a bank suddenly runs out of liquidity and is forced to sell assets and thus realise these losses. This was the case at SVB (more on this in the section "Bonds").

The danger then is that investors and clients lose confidence in other institutions or even in the entire system. A loss of confidence can have fatal consequences (see the example of Credit Suisse in the section "Bonds").

The fact that authorities intervened rapidly helped contain the crisis, at least for the time being. In the last week of March, bank stocks globally rose again by more than 4 %. The coming weeks will show whether this recovery will continue in the medium term. Either way the changed market conditions will likely increasingly reveal misallocations in the area of balance sheet and/or liquidity management.

US banks*: Unrealised gains (losses) on securities



*All FDIC-insured institutions.

Sources: Baloise, Federal Deposit Insurance Corporation (FDIC)
Sources: Baloise, Bloomberg Finance L.P., as at 03.04.2023

Risks may also be found outside the banking sector. Companies that were able to finance themselves at extremely favourable conditions in the last decade are now confronted with drastically higher financing costs. We already pointed out this stress test in our last market report.

Implications for investors: In our baseline scenario we assume that the crisis will be contained. But even if there are no systemically relevant contagion effects, the environment is likely to exhibit further volatility in the short term. After all, SVB and Co. are unlikely to be the last collateral damage of the rate regime change.

Against this background, we prefer a defensive asset allocation. Selection is central in all asset classes, as the wheat is now likely to be increasingly separated from the chaff.

Monetary policy: a balancing act

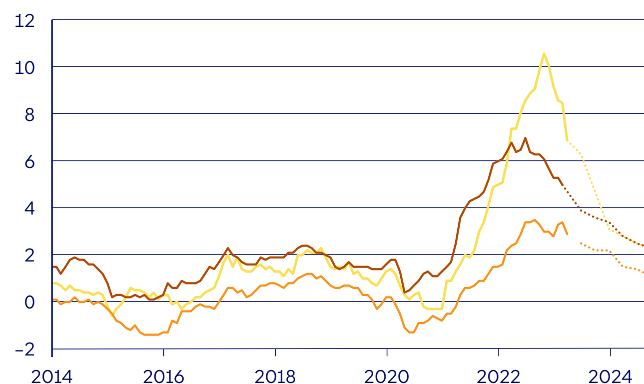
The uncertainty in the banking sector makes the job of central banks more difficult. On the one hand, inflation is clearly too high, on the other hand, the banking crisis likely to further tightens financial conditions. How strong this effect will be, however, is still unclear.

If central banks tighten their reins too much, financial stability is jeopardised and the probability of a hard landing increases. If they are too cautious, they risk not only failing to get inflation under control, but also losing their credibility.

In March, the central banks remained resolute in their fight against inflation. We expect further rate hikes in the second quarter. However, central banks are likely to become more cautious and increasingly guided by the latest economic data.

Inflation

In % over previous year, projections based on Bloomberg consensus forecasts.



The inflation measure shown for the US is the consumption deflator (PCE), which is the Federal Reserve's preferred measure.

Sources: Baloise, Bloomberg Finance L.P., as at 03.04.2023

The **US Federal Reserve** (Fed) raised its policy rate twice by 25 basis points (bp) in the first quarter to a target range of 4.75 % to 5 %. In its own assessment, the Fed believes that a policy rate of 5.13 % is appropriate for this year. So far, it has no intention of lowering rates this year. Investors see things differently due to the banking turmoil. The market-implied rate for the US is currently at 4.34 % for the end of 2023.

The Fed is also sticking to its plan to reduce the balance sheet by up to USD 95 bn per month.

The **European Central Bank** (ECB) also began to gradually reduce its securities holdings in March, after eight years of balance sheet expansion. The redemption amounts of securities at maturity are no longer fully reinvested, so that until the end of the second quarter of 2023 the holdings will be reduced by an average of EUR 15 billion per month. However, in the event of further market tensions, the ECB is prepared to support the financial system with liquidity if necessary.

To ensure price stability, the policy rates were raised for the second time this year by 50 bp. This means that ECB interest rates in the euro area are now as high as they were last in 2008.

The Swiss National Bank (SNB) also raised its policy rate in March by 50 basis points to 1.5 %, a 15-year high. To curb imported inflation, the SNB is also increasingly active in the foreign exchange market. In the fourth quarter of 2022, it sold foreign exchange worth CHF 27 billion. In the previous quarter, it sold only CHF 739 million.

Bonds: Strong interest rate volatility

Review: Silicon Valley Bank (SVB) is at the centre of the banking crisis. Its clients were primarily tech start-ups, which were forced to withdraw deposits due to the declining momentum in the sector. This forced SVB to sell bonds that should have been held to maturity prematurely at high losses. Although the SVB focused its investments on low-risk US government bonds, the losses resulting from the drastic rise in interest rates were too high to provide sufficient liquidity.

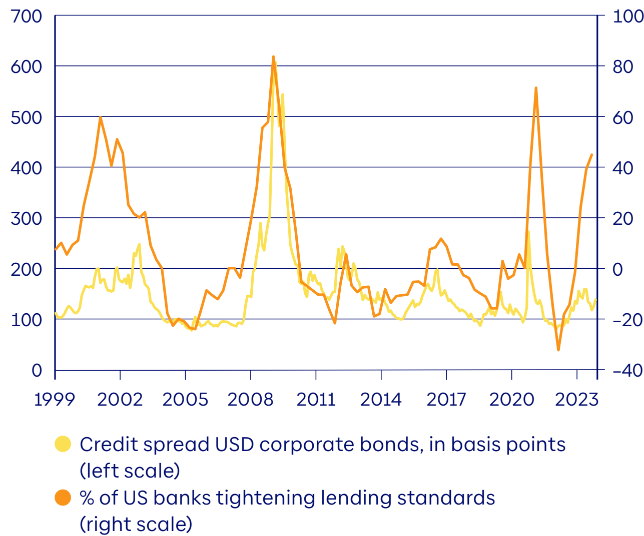
When First Republic Bank was about to fail as well after many customers withdrew their deposits, major American banks joined forces and agreed to support the bank with liquidity.

The uncertainty in the banking sector came at the worst possible time for Credit Suisse, which in the past regularly reported losses and often attracted attention due to poor risk management practices. In the fourth quarter of 2022, it reported capital outflows of over CHF 100 billion, a trend that it was imperative to break, but which only intensified in such a volatile market. Even the SNB's promise to provide up to CHF 50 billion in liquidity did not help restore confidence in the bank. In the end, the bank was taken over by UBS.

In response to the banking crisis, interest rate volatility shot up, especially at the short end of the yield curve, and credit spreads in the financial sector experienced widened. The overall market reaction was more restrained.

Credit spreads for USD corporate bonds did widen by more than 30 basis points on average in March. At the end of the quarter, however, the spreads were only 8 basis points above the level at the beginning of the year and only slightly above the median of the last 20 years.

USD corporate bonds



Sources: Baloise, Bloomberg Finance L.P., as at 03.04.2023

Outlook: We see the fact that the major US banks and the authorities have clearly signalled their willingness to provide liquidity should systemically important banks get into difficulties as a very positive sign and a reason that the situation should stabilise.

Our focus is rather on efforts to fight high inflation. The surprising news from the OPEC+ members to cut oil production until the end of the year will create additional price pressure.

As we expect central banks to maintain their restrictive policy (see section "Monetary policy"), lending standards are likely to tighten and financing costs to rise further. In such an environment, consumers and companies will invest and consume less. This puts pressure on sales and earnings. Companies that have little pricing power will also have to accept lower margins.

Spreads on corporate bonds are therefore too low in our view in the US, especially in the BBB segment.

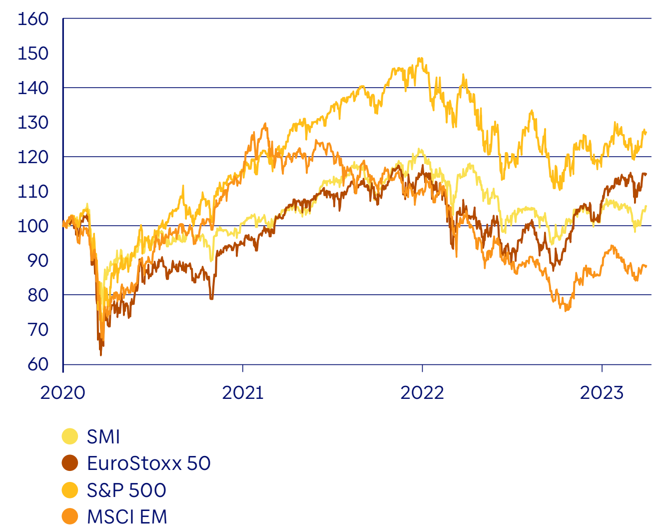
Equity: Diversification is key

Review: Equity investors started 2023 with a lot of optimism. European stock markets posted double-digit gains in the meantime, thanks to better-than-expected economic data and sharply declining natural gas prices. Headwinds were seen in February when it became clear that inflation would remain stubbornly high. A few weeks later, the collapse of Silicon Valley Bank rattled markets.

Not surprisingly, bank stocks were among the biggest losers in the first quarter. The MSCI World Bank Index fell by 4.8 %.

Despite the turbulence, it was a positive first quarter overall for equity investors. The EuroStoxx 50 was one of the strongest performers (+14 %). The gains were more subdued in other regions. The SMI and the MSCI Emerging Markets Index were around 3.5 % above their closing prices at the end of 2022, while the S&P 500 achieved a performance of 7 %.

Equity market performance



Sources: Baloise, Bloomberg Finance L.P., as at 03.04.2023

Outlook: We expect a volatile second quarter for equity markets. Inflation reports and developments in the banking sector are likely to be closely followed by investors.

In the higher interest rate environment, there are again alternatives to shares. Within equity investments, a differentiated view is therefore advisable.

In terms of regions, US equities are particularly unattractive in the context of higher interest rates. In terms of sectors, consumer staples or healthcare tend to be more defensive, with companies with high pricing power and low financing needs best positioned.

Diversification remains essential, as the case of Credit Suisse shows. The bank stock fell by over 55 % on the first trading day after the announcement of the takeover by UBS. The overall market, as measured by the Swiss Performance Index, rose by 0.3 % at the same time.

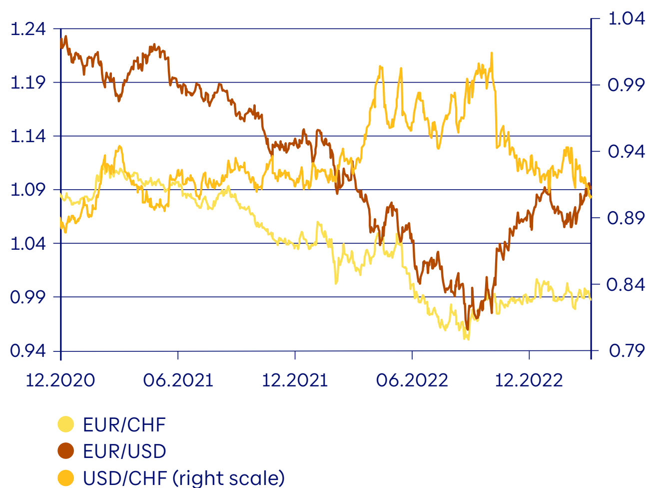
Currencies: Driven by monetary policy

Review: The foreign exchange market mainly reflected expectations regarding monetary policy and, in-between, investors' risk aversion.

The expectation that the ECB's monetary policy could be tightened more contributed to a slight appreciation of the euro. It gained just under 1.25 % against the USD in the first quarter.

The turmoil in the global financial sector in March caused exchange rate fluctuations. The Swiss franc, a safe haven currency, gained around 2.4 % against the euro in the first two weeks of March. As investors' concerns turned to the Swiss financial system, however, the franc depreciated significantly. At the end of the quarter, the euro stood at 0.99218 francs, which corresponds to an appreciation of the euro of 0.3 %.

Development currencies



Sources: Baloise, Bloomberg Finance L.P., as at 03.04.2023

Outlook: We assume that US dollar strength has peaked. And as we expect more interest rate hikes in the euro area than in the US, the euro should appreciate against the USD in the medium term.

However, a possible geopolitical escalation in Ukraine poses a significant risk to the euro. In this environment, the Swiss franc would continue to benefit as a safe haven. We expect the euro-franc exchange rate to continue trading around parity in the second quarter.

Real Estate Switzerland

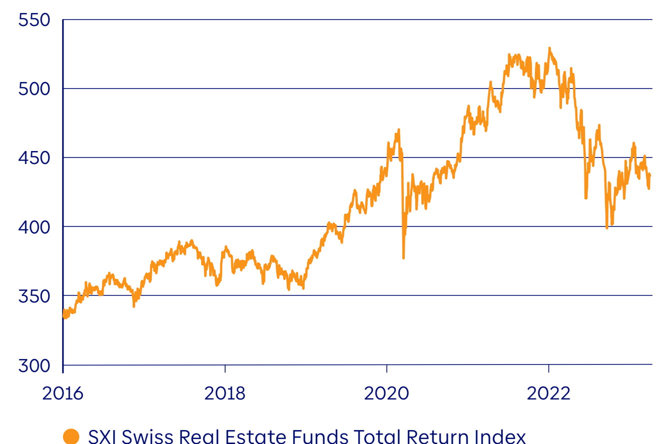
Review: In Switzerland, there were four interest rate hikes totalling +225 basis points (from –0.75 % to 1.5 %) within one year. The last interest rate step was already largely priced in by real estate investors before the decision. This can be seen from the fact that the SXI Real Estate Funds Broad Total Return Index, among others, hardly reacted significantly after the last interest rate decision on 23 March 2023. The index closed the first quarter of 2023 at 438.26 points and thus with a performance of –0.4 %.

The rise in interest rates is also increasingly noticeable in the direct real estate market. According to Fahrländer Partner (survey of eight valuation companies), the minimum discount rates for multi-family houses have been slowly but steadily rising since mid-2022.

However, there continue to be positive signals in the Swiss real estate market, especially regarding the demand for rental properties. The net migration of the permanent resident population in 2022 increased by 32.2 % or around 20,000 persons compared to the previous year and is also at the high level of the previous year for January 2023. In addition, home ownership has become somewhat less attractive relative to rental housing due to rising interest rates, which should have a positive effect on the demand for rental housing, as should the continuous increase in the average amount of space required per inhabitant over the last few years in Switzerland.

Demand for office space has also developed positively recently thanks to strong employment growth.

Development of Swiss real estate funds



Sources: Baloise, Bloomberg Finance L.P., as at 03.04.2023

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Outlook: Inflation and interest rate developments will continue to be the focus of real estate investors in the coming quarter.

However, the consistency of the properties' cash flows should remain attractive in the following months. The impulses described above should continue to have a positive influence on the demand for rental flats soon. This is contrasted by restrained construction activity – the construction price tax, higher interest rates as well as increasing regulation are having a negative impact.

The office space market is likely to cool down somewhat again in the coming months. This is a consequence of slowing economic growth.

In general, it is positive to note that rising interest rates also mean a certain potential for rent increases in a wide range of sectors (see Market Outlook 4th Quarter 2022).

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

Baloise Asset Management Ltd
Aeschengraben 21
4002 Basel
baloise.ch

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