soundcapital

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The market now expects four US rate hikes

Inflation expectations levelled off slightly

Rate sensitive assets under pressure

US companies kicked off a strong earnings season

Asset allocation remains unchanged

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Rising pressure on central banks

Inflation prompts mounting urgency on fed to speed up taper

What was already apparent at the end of last year has intensified since the beginning of this year: 2022 will mark the end of loose monetary policy to combat an unexpectedly persistent rise in inflation.

With an increase of 7% over the last 12 months, inflation in the US reached the highest level since 1982. Although December figures were in line with expectations and did not come as a surprise to investors, interest rates have nevertheless continued to grind higher since the beginning of the year. The reasons for this situation are the numerous voices of well-known investors and members of the Federal Reserve, who are calling for more rapid action to tame inflation. While three interest rate hikes by the Federal Reserve were expected in December last year, four are now priced into the market.

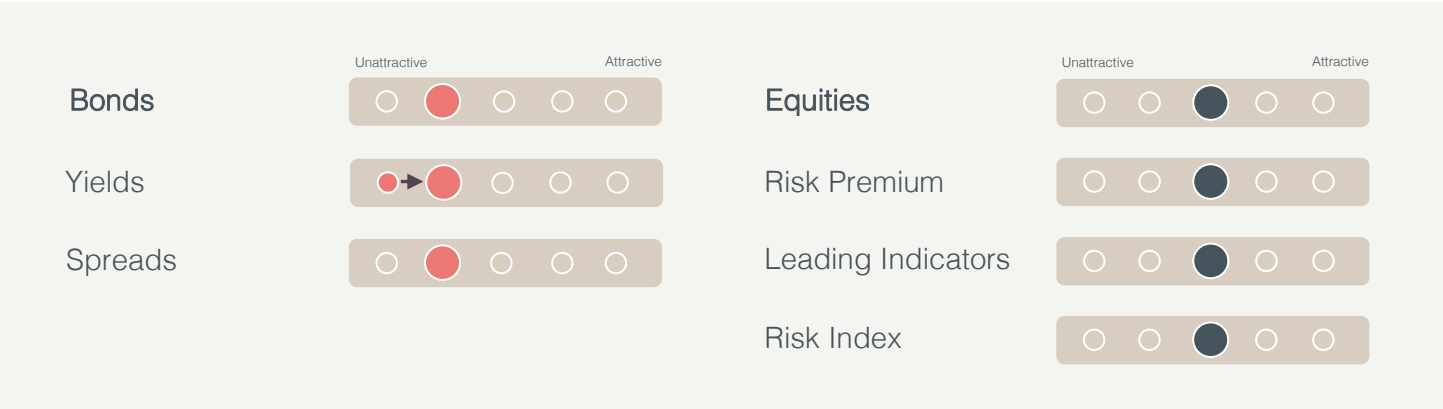
The US Federal Reserve is expected to start raising the federal funds rate in March - two years after lowering it close to zero at the beginning of the pandemic in March 2020. Tailwind is provided by reports out of the bureau of labor statistics, which showed that the US unemployment rate fell to 3.9% in December, approaching the pre-pandemic low of 3.5%. Fed Chairman Jerome Powell confirmed in January that the Fed is ready to act decisively: "High inflation is a serious threat to the goal of full employment".

In contrast to previous months, long-term interest rates have moved in lockstep with rising short-term rates since the beginning of the year. Thus, the yield curve did not flatten further. As a result, the volatility of interest-sensitive assets has been high. In the case of bonds, longer maturities, which we have been warning against for some time, came under pressure particularly.

The current rate development also has a strong impact on the stock market. In particular, higher yields have an impact on company valuations via the discounting effect, as an increase in rates leads to a lower present value of expected future cash flows. Companies with high growth prospects and in turn elevated valuations have therefore been under pressure since the beginning of the year. The beneficiaries of the expansionary monetary policy are now facing headwinds for the first time in a while.

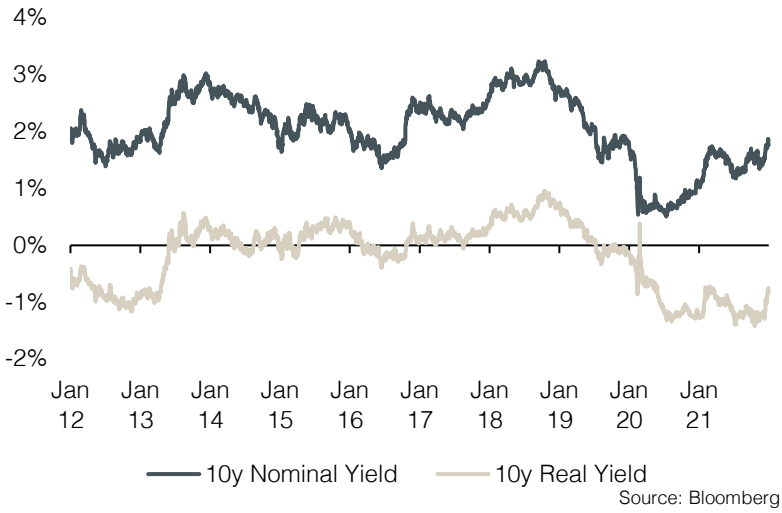
However, we do not see a reason for much concern at the moment. While interest rate expectations are rising, expected inflation is falling, which signals a successful handling of the situation by the Federal Reserve. Moreover, the expected long-term earnings growth of companies reveals a glimpse of a post-pandemic world and shows a healthy development. Furthermore, earnings releases for the fourth quarter of last year have also exceeded analysts' expectations so far.

We have not made any changes to our asset allocation and remain underweight fixed-income investments with a focus on short maturities. In equities, we aim to diversify broadly and avoid high valuations without corresponding quality.



Yields

US nominal rates vs. expected real rates



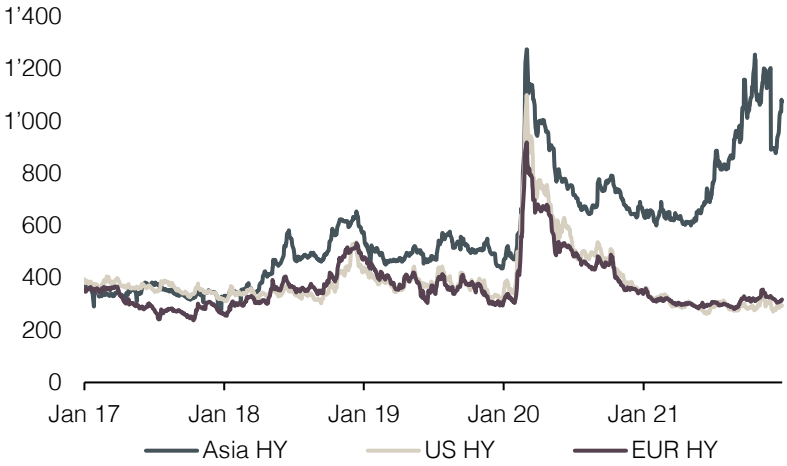
Source: Bloomberg

View:

Nominal interest rate on government bonds have recovered strongly since the pandemic low and, in the case of the US, are once again trading at levels last seen before COVID-19. As a result, our assessment on government bonds has increased by one notch, but has no impact on the overall rating of fixed income investments. Higher nominal interest rates are currently accompanied by high inflation expectations, which means that real yields remain unattractive. Looking at the expected real yield, it is noticeable that the current value is still far away from the pre-pandemic level.

Spreads

High Yield Spreads (in bps)



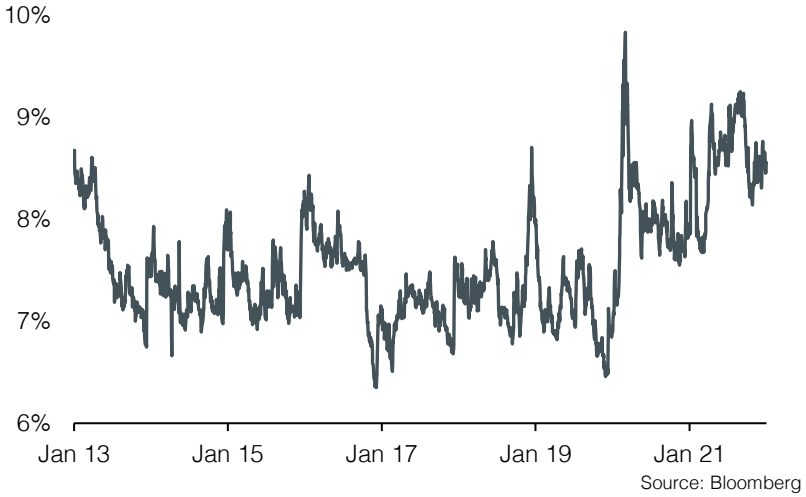
Source: Bloomberg

View:

Despite rising interest rates and higher market volatility, global bond spreads remain largely unchanged. We continue to see record low spreads for high yield bonds in developed countries and avoid positions in this area. We continue to see the most attractive opportunities in Asia. The situation in China has still not settled and with pressure on Country Garden, the country's largest real estate developer, stress has spilled even into the investment grade space. However, while defaults are expected in the high yield space, the market offers attractive opportunities in the long run.

Equity Risk Premium

Equity Risk Premium USA



View:

Despite slightly lower stock levels, there was no material change in risk premiums. A look at the US stock market paints an attractive picture, especially when considering alternative opportunities.

Leading Indicators

The global purchasing managers' indices have weakened slightly, particularly in the service sector. Renewed restrictions caused by the Omicron variant are clearly visible in the US. Nevertheless, the leading indicators remain at a comfortably high level and continue to point at an economic expansion. However, we take the declining trend into account and maintain a neutral rating.

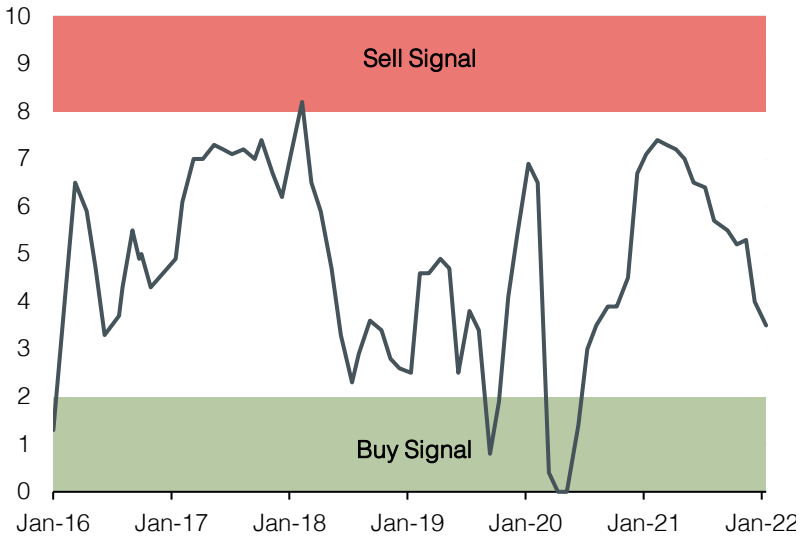
View:

Services PMI

	Apr 20	May 20	Jun 20	Jul 20	Aug 20	Sep 20	Oct 20	Nov 20	Dec 20	Jan 21	Feb 21	Mar 21	Apr 21	May 21	Jun 21	Jul 21	Aug 21	Sep 21	Oct 21	Nov 21	Dec 21
World	23.7	35.2	48.1	50.7	52.0	52.0	52.9	52.2	51.8	51.6	52.8	54.7	57.0	59.5	57.5	56.3	52.8	53.8	55.6	55.6	54.6
United States Markit	26.7	37.5	47.9	50.0	55.0	54.6	56.9	58.4	54.8	58.3	59.8	60.4	64.7	70.4	64.6	59.9	55.1	54.9	58.7	58.0	57.6
Eurozone	12.0	30.5	48.3	54.7	50.5	48.0	46.9	41.7	46.4	45.4	45.7	49.6	50.5	55.2	58.3	59.8	59.0	56.4	54.6	55.9	53.1
Germany	16.2	32.6	47.3	55.6	52.5	50.6	49.5	46.0	47.0	46.7	45.7	51.5	49.9	52.8	57.5	61.8	60.8	56.2	52.4	52.7	48.7
United Kingdom	13.4	29.0	47.1	56.5	58.8	56.1	51.4	47.6	49.4	39.5	49.5	56.3	61.0	62.9	62.4	59.6	55.0	55.4	59.1	58.5	53.6
France	10.2	31.1	50.7	57.3	51.5	47.5	46.5	38.8	49.1	47.3	45.6	48.2	50.3	56.6	57.8	56.8	56.3	56.2	56.6	57.4	57.0
Italy	10.8	28.9	46.4	51.6	47.1	48.8	46.7	39.4	39.7	44.7	48.8	48.6	47.3	53.1	56.7	58.0	58.0	55.5	52.4	55.9	53.0
Spain	7.1	27.9	50.2	51.9	47.7	42.4	41.4	39.5	48.0	41.7	43.1	48.1	54.6	59.4	62.5	61.9	60.1	56.9	56.6	59.8	55.8
Switzerland	21.4	37.4	49.0	50.9	50.5	53.6	50.3	48.4	49.5	49.1	52.0	55.5	57.6	58.8	64.4	60.8	61.3	62.1	59.4	58.0	59.3
China Local	52.1	52.3	53.4	53.1	54.3	55.2	55.5	55.7	54.8	51.1	50.8	55.2	54.4	54.3	52.3	52.5	45.2	52.4	51.6	51.1	52.0
Japan	21.5	26.5	45.0	45.4	45.0	46.9	47.7	47.8	47.7	46.1	46.3	48.3	49.5	46.5	48.0	47.4	42.9	47.8	50.7	53.0	52.1

Description: The Purchasing Managers' Index (PMI) is a forward-looking economic indicator based on company surveys. A value above 50 indicates an improving economic environment, whereas a value below 50 indicates a worsening environment.

Risk-Index



View:

Investor sentiment has continued to decline over the past month and shows a rather pessimistic positioning of investors. The additional volatility in the market is likely to be one of the reasons why sentiment has declined again over the last few weeks. We keep a neutral assessment.

Appendix:

Sound Invest is the central tool for our investment allocation. We use it to systematically and consistently assess the aspects that are relevant to the development of the financial markets. As a result, our clients can rely on a rational and anti-cyclical implementation of our investment decisions.

- **Focusing on the essentials:** Interest rate level, risk premium, valuation, economic development, investor sentiment and positioning. These are the decisive factors for success on the financial markets, especially in turbulent times when the temptation to react irrationally to the headlines is particularly strong.
- **Comparability over time and place:** The factors mentioned above are equally relevant for all markets and at all times. This is the result of a strict «backtesting» process that continues into the future.
- **Cumulating our investment experience:** Our strength lies in the many years of experience of our partners and principals. It is precisely this experience that we summarize and make it applicable with Sound Invest.
- **Transparency:** Thanks to our monthly publication, our clients always know where we stand in the investment cycle and how we expect the financial markets to develop.

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Datasource: Bloomberg, BofA ML Research