soundcapital

June 2022

Most turbulent period since the global financial crisis

Fighting inflation is now on top of the Fed's agenda

Adding US-Government bonds to diversify risk

Equity valuations remain in focus

Economic momentum and inflation expectations declined

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Outlook for the second half of the year

At mid-year, global equity markets are in a bear market. Opportunities seem within reach, but require discipline and the right focus.

By any measure, 2022 has been a very challenging year for investors so far. Although various equity indices reached new record highs at the beginning of the year, almost all asset classes saw exclusively negative developments thereafter. Equity investors experienced the most turbulent period since the outbreak of the global financial crisis. Bond markets recorded the sharpest decline on record. As a result, both conservative and dynamic investors suffered significant losses and continue to face volatile markets. In this environment of high uncertainty, investors often tend to have a short-term focus and overreact on market swings. While the greatest long-term opportunities arise in precisely these volatile market phases, the greatest mistakes are also made at the same time - after all, for every seller there is also a buyer. A clear focus on plain and relevant data is therefore crucial. This Sound Invest issue focuses on our data-based assessment of markets, potential economic developments and what is going to be important when investing over the coming months.

What happened?

While inflation already rose last year in the aftermath of the pandemic-related monetary and fiscal policy measures, the war in Eastern Europe escalated the situation. Major economists saw the main cause for ongoing price increases in the imbalance between supply and demand and thus as a temporary phenomenon. Rapidly rising inflation figures around the globe have since revealed this assumption to be simply wrong.

Epic U-Turn of central bank policy

For many months, central bank policy makers have also trusted the narrative that inflation was a temporary phenomenon that could be brought under control in a timely manner by raising key interest rates on data dependency. Nevertheless, the market had already anticipated tighter monetary policy and clearly signaled that central banks were lagging behind the inflationary development. In May, Fed Chairman Jay Powell raised rates by 0.50% (the largest rate hike in 22 years) but made clear that 0.75% steps were not planned. Again, in June, the pressure of the markets became too big and forced the Fed to raise the key rates by 0.75% to 1.75% which however was already priced into the market (the largest interest rate step in 28 years). By the end of the year, another seven interest rate steps up to approx. 3.5% are expected by market participants.

Much more drastic than the heavy lifting of interest rates, however, was Powell's choice of words at the last press conference: "Our effort to curb inflation is unconditional. We're going to want to see evidence that it really is coming down before we declare 'mission accomplished." A powerful commitment by the Fed, for which inflation is now a top priority and for which a recession will probably be tolerated in order to fight it.

What does that mean for investors?

Current developments and the decisive actions of the central banks will continue to create a volatile market environment in the coming months. Strong fluctuations will stick with us until there is certainty about the further development of inflation. Many investors with a short-term focus will disproportionately react to macroeconomic data, even though it may be insignificant in the long run. The epic change in central bank policy also marks the end of the era of the rising monetary tide, which has lifted almost all boats over the past few years. What is now required is an active approach and discipline to avoid mistakes, but also to be prepared for extraordinary opportunities.

Fixed Income: Expected returns have risen sharply

For fixed income investors, tighter monetary policy entails not only higher interest rates but also rising credit spreads. Thus, return expectations have increased significantly, but in our view, are currently unevenly distributed. While long-term bond yields in the US appear increasingly attractive, Europe's interest rate development is lagging behind. This is in line with the central banks actions, although the Swiss National Bank, unlike the ECB, has already followed the Fed in raising rates. Nevertheless, the ECB is also expected to raise key interest rate to 1% by the end of the year, i.e. around 1.50% higher than today.

The end of ultra-loose monetary policy once again reveals the negative aspects of the European Union: The ECB has not yet hiked interest rates but already had to hold an extraordinary meeting to assess the negative impact going forward. Government bonds of highly indebted countries such as Italy have come under heavy pressure, as higher rates could possibly make the debt servicing costs unsustainable. Just a few days ago, 10-year Italian government bonds were yielding over 2% more than German government bonds of the same maturity. This is a clear warning that higher interest rates are likely to increase the default probabilities of corporate bonds as well.

However, we also see positive takeaways when looking at the interest rate development. Negative interest rates in EUR and CHF will be a thing of the past by September at the latest. As described in the last Sound Invest issue, this means that there is finally a real alternative to equities. On average, the yield on the EUR corporate bond aggregate index surpassed 3%, the highest level in 10 years. In USD, yields for first-class corporate bonds are trading close to 4.5%. Despite current high inflation prints, these yields already exceed long-term inflation expectations. In contrast to equities, lower bond prices automatically result in higher future returns. For investors, it is therefore essential to put this year's capital losses in contrast with the future return prospects. This prevents past developments from becoming short-term decisions and long-term failures. It is obvious that bonds are increasingly coming back into investor focus. However, it is important to proceed with appropriate caution - which is why we stick with an underweight in bonds for the time being.

The development of inflation remains the key issue to pay attention to. The rigorous actions of the Fed seem to be having an effect: since the last interest rate hike, 2-year inflation expectations have fallen from over 4.7% to below 4%. At the same time, however, leading economic indicators have come under pressure, signaling an increased risk of recession. This is clearly visible when looking at the USD yield curve: The difference between 5-year and 30-year US government bonds traded below -0.18%, a level not seen for over 20 years. Furthermore, there is an inversion of the entire USD yield curve 6 months from now, when looking at interest rate swap forwards. Thus, the market already seems to be certain: the Fed will quickly get inflation under control, but trigger a recession while doing so. As a result, interest rates are likely to fall again at a later stage.

This creates opportunities to invest in USD government bonds and to gradually extend the duration in the USD segment. From the perspective of a diversified portfolio allocation, US government bonds are likely to also fulfill their purpose as a buffer, especially in a recessionary environment. For EUR and CHF bonds, we continue to be cautious with regard to longer maturities. Despite the rising trend, credit spreads are not yet in an attractive range, which means that recession risks are not yet sufficiently priced in. We therefore shy away from taking too much credit risk.

Equities: Valuation is back in focus

Almost 14 years have passed since the outbreak of the financial crisis, during which central banks around the world have significantly expanded their balance sheets. Due to the flood of cheap money for years, the stock market was increasingly driven by momentum and sentiment. This happened over such a long period of time that few investors were able to escape the trend. The result were valuations that seem exaggerated in today's context, but were normal in a zero-interest rate environment.

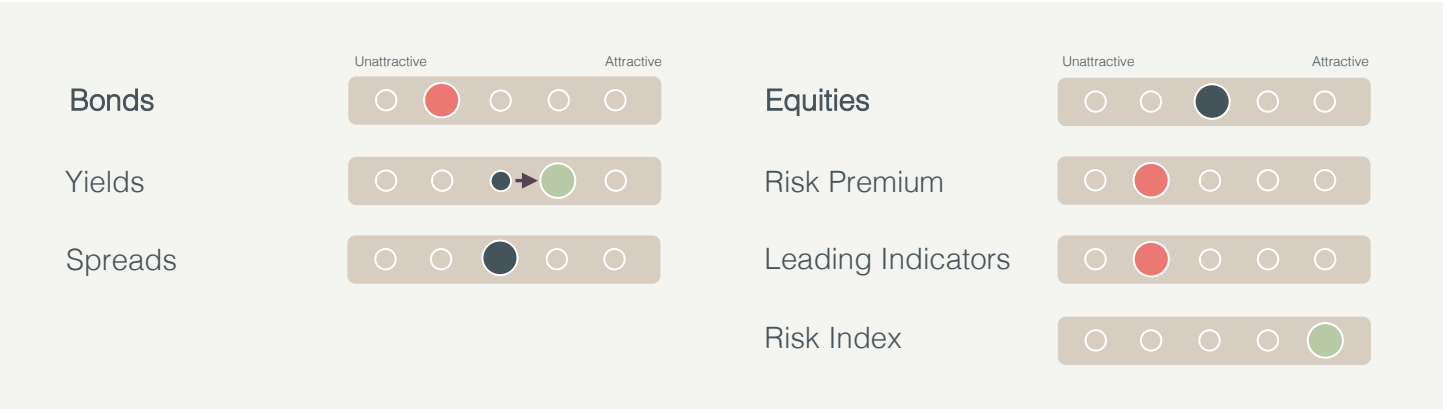
Strong headwinds triggered by rising interest rates brought fundamental valuations back into focus when selecting stocks. Attractively valued markets and sectors benefited from this. Over the coming months, a disciplined approach to selecting solidly valued companies with predictable earnings streams will be crucial for successful investing. The rising risk of a recession calls for comprehensive risk awareness - but also a clear focus on essentials: As measured by our countercyclical risk indicator, investor sentiment has reached the most pessimistic level since the outbreak of the pandemic. Some institutional investors and pension funds are likely to rebalance their equity exposure, which has fallen as a result of the market turmoil, thus triggering strong reversals in equity markets.

The prospect of a successful fight against inflation is good news for investors that stick to a long investment horizon. Valuations as measured by estimated price-to-earnings ratios reached the most attractive levels since the 2020 pandemic low, particularly in Europe. Still, caution is warranted - corporate earnings will decline in many sectors, negatively impacting valuations and the economic environment. Economic predictions from the Federal Reserve Bank of Atlanta already point to zero economic growth in the second quarter.

Given the flattening economic momentum, we advise a defensive stance in equities and avoid companies with uncertain earnings profiles. We consider a tactically increased liquidity allocation to be sensible in order to have the necessary flexibility for long-term opportunities in case of further market fluctuations. Purchases of equities should preferably be made in several steps in the event of clear spikes in volatility. In case of a strong decline in volatility, hedging via put options can be considered.

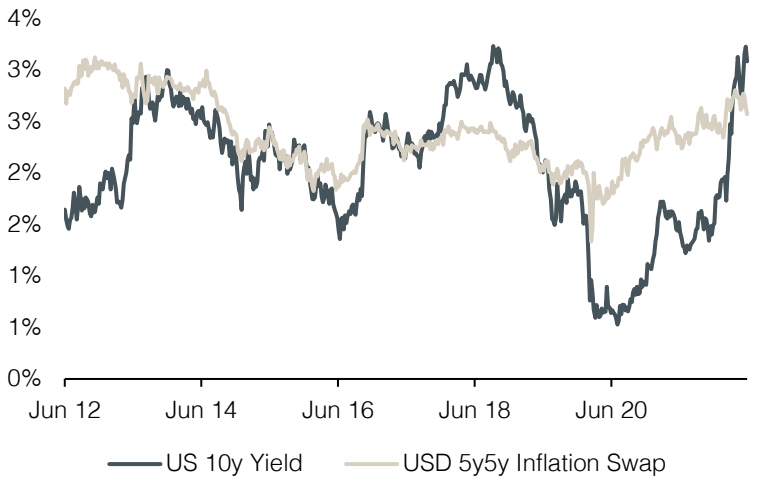
Alternatives play an important role

For alternatives, the current environment is the time to shine as they have proven their qualities and increased stability across all investment strategies. Thus, the area of non-correlated investments was one of the few places to generate profits this year. The environment for alternatives will be favorable over the coming months. They are precisely the most stable part of a portfolio which, in addition to cash, makes it possible to seize opportunities as they arise in the event of extreme market distortions. Thus, our recommendation remains to keep an overweight of alternative investments in a broadly diversified and robust portfolio, but to focus on strategies with low volatility and elements with low correlation to equity and bond markets. This results in a comfortable position in uncertain markets and provides room to maneuver at the decisive moments where one can take advantage of long-term opportunities.



Yields

US Treasury Yield vs. Inflation Expectation



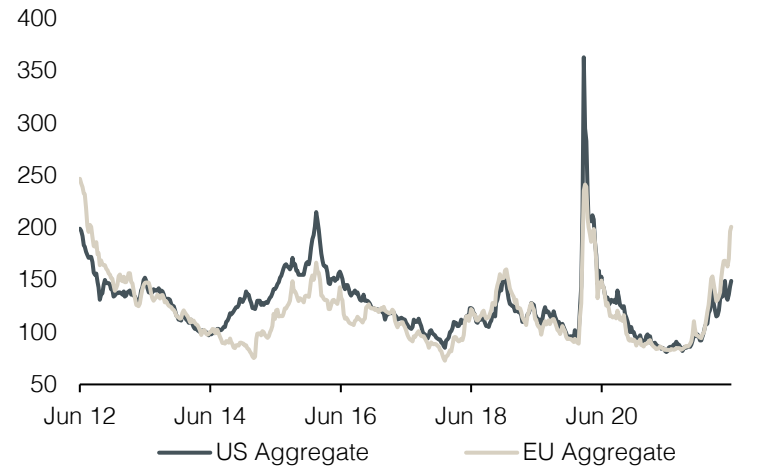
Source: Bloomberg

View:

Yields on 10-year US government bonds are already above long-term inflation expectations and thus appear attractive. In contrast to EUR government bonds, where there is still some upside potential in rates, high-quality USD bonds increasingly represent an attractive option. In combination with a weakening inflation and economic outlook, we consider U.S. government bonds to be a useful addition to portfolios, which should also result in positive diversification effects.

Credit Spreads

Spread (in bps)



Source: Bloomberg

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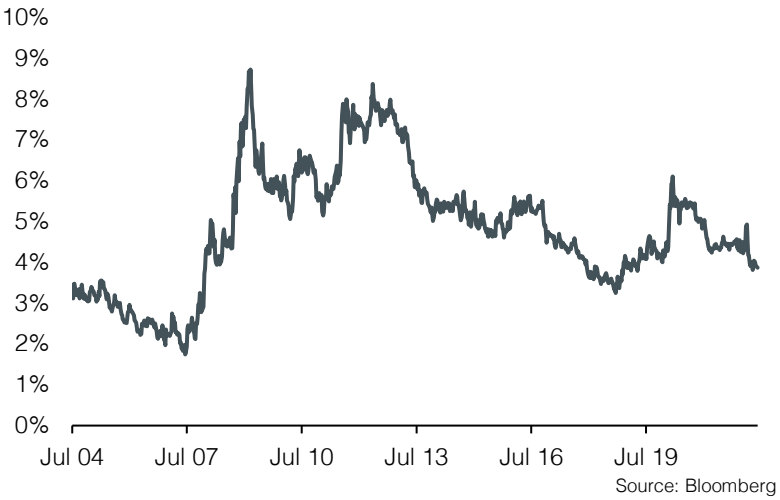
Credit spreads have clearly increased, but are not yet in the attractive range. While Europe experienced a larger spread widening, credit spreads in the US still remain low despite facing increased recession risks. The historical comparison over the last 10 years must also be taken with a grain of salt: In the current environment, companies are facing the burden of higher interest rates for the first time in years - which, in our view, should result in better entry points for credit risk going forward.

Equity Risk Premium

Global Shiller Equity Risk Premium



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Despite falling share prices, sharply higher interest rates have led to a lower risk premium. A rise would require further market dislocations, for which it is currently necessary to position oneself. Particularly with regard to the forward-looking risk premium that includes analyst estimates. It can be assumed that analysts are likely to revise their earnings expectations downward in the coming reporting season, which will put the equity risk premium under pressure by deteriorating earnings as well.

Leading Indicators

What stocks are already anticipating is evident when looking at June PMI prints. With the exception of Asia, most indicators are weakening towards the expansionary level of 50. Particular attention should be paid to China, where there could be a trend reversal for the better after lockdown restrictions were lifted. We are watching for signs of a bottom, but so far fail to see evidence for it.

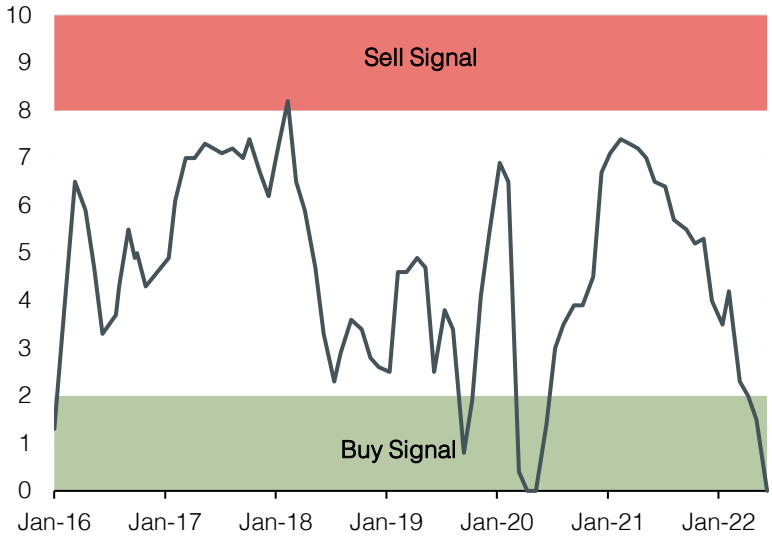
View:

Services PMI

	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	Jan 22	Feb 22	Mar 22	Apr 22	May 22	Jun 22
World	52.0	52.9	52.2	51.8	51.6	52.8	54.7	57.1	59.5	57.5	56.3	52.8	53.8	55.6	55.6	54.7	51.0	54.0	53.4	52.2	52.2	
United States Markit	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	51.2	56.5	58.0	55.6	53.4	51.6
Eurozone	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	51.1	55.5	55.6	57.7	56.1	52.8
Germany	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	52.2	55.8	56.1	57.6	55.0	52.4
United Kingdom	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	54.1	60.5	62.6	58.9	53.4	53.4
France	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	53.1	55.5	57.4	58.9	58.3	54.4
Italy	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	48.5	52.8	52.1	55.7	53.7	
Spain	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	46.6	56.6	53.4	57.1	56.5	
Switzerland	53.6	50.3	48.4	49.5	49.1	52.0	55.5	57.6	58.1	62.7	60.4	60.2	60.9	59.3	59.2	59.9	56.4	64.3	61.1	56.2	60.2	
China Local	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	50.3	50.5	46.7	40.0	47.1	
Japan	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	47.6	44.2	49.4	50.7	52.6	54.2

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



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After the risk index last fell to zero during the pandemic, investor sentiment is back at the lowest level for the second time in almost 2 years. The pessimism of market participants leads us to believe that reversals to the current market downturn could be very strong. However, when breaking down the indicator components, the capitulation can mainly be observed in the area of bonds, but not in equities yet.

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.

Datasource: Bloomberg, BofA ML Research