soundcapital

Sound Invest

October 2022

Fixed income markets post largest losses on record

Key interest rates rise to the highest level since the financial crisis

Neutral bond allocation to be increased gradually

Equity positioning remains defensive

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The perfect storm

Bonds are suffering from unprecedented losses. While investors become increasingly nervous, it is worth looking at current opportunities and risks.

Record high inflation, sharply rising interest rates and geopolitical turmoil are the main challenges for investors this year. Since the beginning of the year, corporate bonds in the US have lost around 21% and their European counterpart tanked by almost 18%. At the same time, global equity markets have reached new lows. Putting this year's bond returns in a historical context reveals the unprecedented scale of the losses.

The decline in investment grade government and corporate bonds significantly exceeds any price drop since records began in the 1970s. Even in the early 1980s with the highest inflation of the post-World War II era, bonds posted better returns than they did in the current year.

This seems surprising given that the US federal funds rate was raised to an all-time high of 20% at that time, much more than in the current tightening cycle. The main reason for the higher losses is that interest rates have risen from very low levels in the current year. Thus, low coupon payments have not compensated investors for high capital losses on a mark-to-market basis. As an example, the average coupon for EUR denominated bonds fell below 1.5% from over 5% since the beginning of the financial crisis and in the aftermath of the zero interest rate environment. Over the same period, at a global level, bond duration has increased by almost 50%, which paved the way for a much higher interest rate sensitivity.

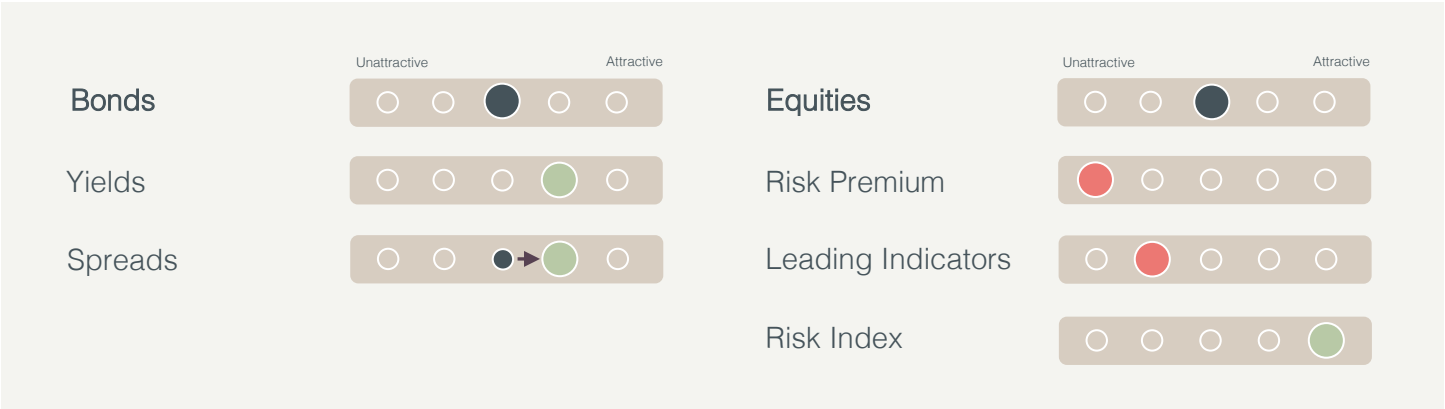
As a result, bonds were not able to unfold their diversification benefit as correlation to equities turned positive during the current market turmoil. Unlike in any market correction before, corporate bonds in EUR and USD are currently suffering higher losses than local equity markets. Hence, investors across all risk profiles are experiencing a "perfect storm".

However, the current interest rate environment also brings opportunities for investors. The yield to maturity of high-quality US corporate bonds has surpassed 6%, the highest level since the global financial crisis. Moreover, government bonds with longer maturities should again serve as a much better diversifier in a portfolio context, given that central banks once again have more leeway to cut interest rates in the event of a severe recession. In summary: Return expectations have increased.

Nevertheless, the high level of interest rates is also leaving its mark on the real economy. At 7.3%, 30-year US mortgage rates are at their highest level in more than 20 years, which has led to a sharp drop in demand for residential real estate. Companies with sub-investment grade credit ratings are paying close to 10% interest on newly issued bonds. Last but not least, the interest burden on governments is also rising significantly. Estimates show that this year, interest payments by the US government are likely to rise by over 45%. These effects are not immediately reflected in the real economy, but the impact is likely to be felt next year.

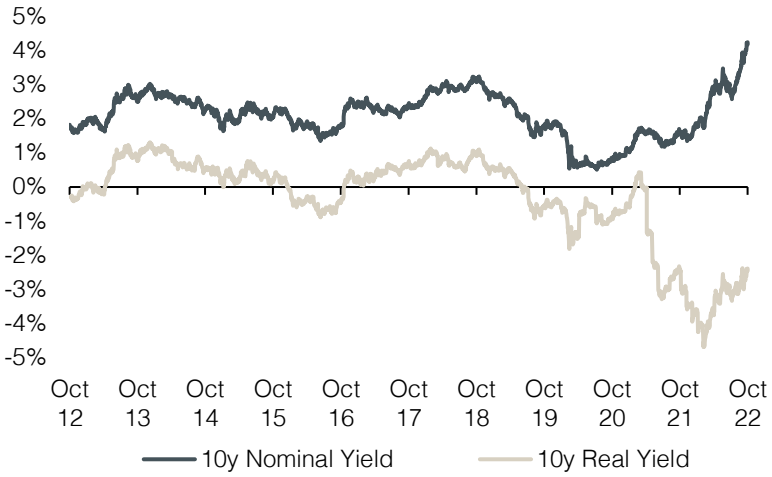
Thus, the positioning of bonds takes center stage for the remainder of 2022. Our indicator model now shows an attractive assessment for bonds, which would generally result in an overweight of the asset class. However, there are enormous differences between the individual currency markets. Especially in the EUR and CHF area, central banks continue to be behind the curve compared to the US Federal Reserve. With the gloomy economic outlook, a recession is becoming increasingly likely, which in our view is not reflected in credit spreads yet. This must be considered when implementing the portfolio allocation. Thus, according to the Investment Committee, there is no hurry to increase the bond quota and therefore we currently remain with a neutral allocation to fixed income, where we overweight government bonds and avoid high credit risks.

In equities, we made no changes and remain defensively positioned with an overweight in Swiss equities. We continue to prefer high-dividend quality stocks and companies in the healthcare space.



Yields

US Nominal Rates vs. Current Real Rates



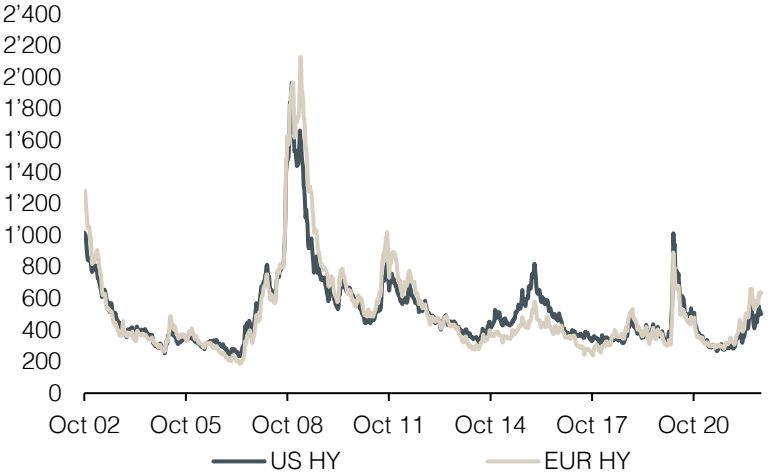
Source: Bloomberg

View:

Global interest rates are approaching their highest levels since the global financial crisis. With the exception of Japan, all central banks have abandoned negative interest rate policies. While nominal yields are thus rising to attractive levels, real yields are still at record low levels. There are first signs of peaking inflation rates. Therefore we prefer to gradually increase our exposure to government bonds and extend duration over the coming months.

Spreads

High Yield Credit Spreads (in bps)



Source: Bloomberg

View:

Credit spreads for US high yield bonds are currently just below 5%. This compares to an average spread over the last 20 years of 5.28%, which means that despite the rising probability of a recession and generally higher interest rates, the default probabilities for high-yield bonds are not yet sufficiently reflected. While credit spreads widened faster in Europe, we stick with the view that overall spreads have not yet reached buying levels. However, strongly rising credit spreads above historical averages are likely to become an opportunity and would result in a gradual increase of portfolio exposure.

Equity Risk Premium

Global Shiller Equity Risk Premium

Source: Bloomberg

View:

Over the last month, there was no change in the equity risk premium, which remained in strongly unattractive territory. As a result of the sharp rise in yields, equities remain unattractive compared to bonds. In the absence of a significant change in inflation expectations or the interest rate level, the assessment of risk premiums is likely to remain unchanged for the time being.

Leading Indicators

The development of leading economic indicators clearly signals a weakening global economy. The consequences of higher interest rates are only now starting to be felt in some areas of the real estate market but are likely to spread throughout the economy over next year. On top of that, the probability of a US recession over the next 12 months has spiked to 60%.

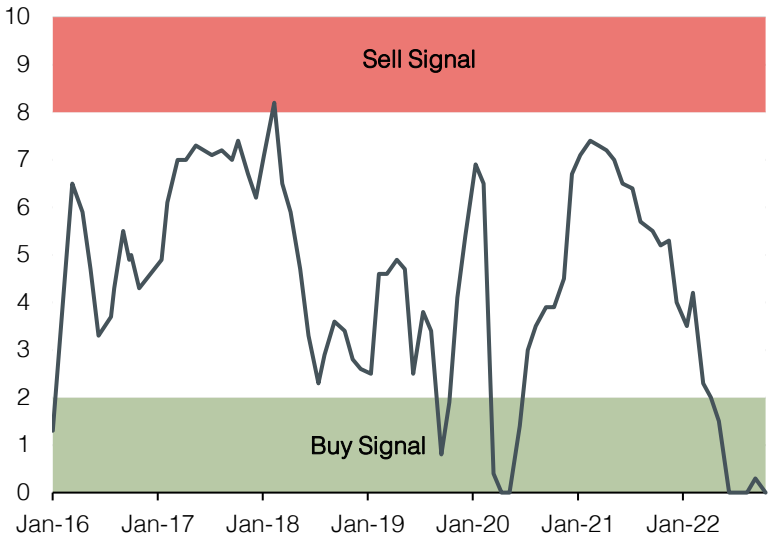
View:

Services PMI

	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	Jul 22	Aug 22	Sep 22	Oct 22
Multi-national	51.6	52.8	54.7	57.1	59.5	57.4	56.3	52.7	53.8	55.6	55.6	54.7	51.0	54.0	53.4	52.2	51.9	53.9	51.1	49.3	50.0	
United States of Americ	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	52.7	47.3	43.7	49.3	46.6
Eurozone	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	53.0	51.2	49.8	48.8	48.2
Germany	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	49.7	47.7	45.0	44.9
United Kingdom	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	54.3	52.6	50.9	50.0	47.5
France	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	53.9	53.2	51.2	52.9	51.3
Italy	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	51.6	48.4	50.5	48.8	
Spain	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	54.0	53.8	50.6	48.5	
Switzerland	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	59.0	55.2	56.9	52.3	
China Local	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	54.3	52.8	51.9	48.9	
Japan	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	54.0	50.3	49.5	52.2	53.0

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:

There was no change in the positioning of investors as the pessimistic sentiment prevails. A survey of fund managers indicated the highest cash holdings and the largest underweight of equities in the past 20 years. A signal of partial capitulation and indication of a potential bear market rally.

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, Credit Suisse Research, (WP)