soundcapital

Investment Returns 2022 & Outlook 2023

2022 & 2023

Bond markets suffer worst year in decades

Most attractive risk-free rates since 2008

Equities reduced to underweight

Defensive sector and country allocation recommended

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From Inflation to Recession

Last year was one of the most difficult years in the history of asset management. In many respects, the past events will resonate into the coming year, promising challenging financial markets in 2023.

In terms of superlatives, 2022 is unlikely to be surpassed anytime soon. The fluid transition from COVID crisis to war and inflation has turned financial markets extraordinarily volatile and provided the weakest investment returns in decades.

However, the last year started on a positive note: A normalization of the global economy through declining infections suggested that discussions about COVID would soon give way to the usual real economic issues. In fact, COVID was soon no longer on top of our minds, but not for the expected reasons. On February 24, 2022, Russia invaded Ukraine, creating the greatest challenge to the international peace order since World War II. Already strained supply chains were further disrupted by a wide range of sanctions. Moreover, protectionist trade restrictions accentuated an already tense situation which ultimately led to a global outbreak of inflation.

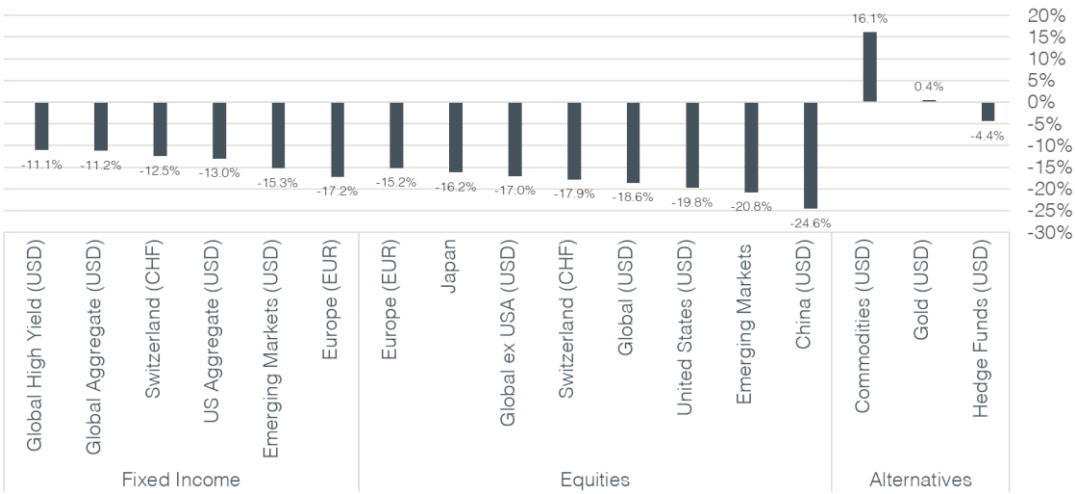
Except for some areas of the commodity market, all asset classes were negatively affected by sharply higher rates caused by central bank tightening. From an investor's point of view, there were almost no possibilities to minimize losses, despite solid diversification.

In historical comparison, losses across the fixed income space were particularly exceptional. The shift away from loose monetary policy to fight inflation was followed by double-digit negative returns across the board. On top of that, it is the second consecutive negative year for bonds after 2021.

In equities, massively higher interest rates impacted valuations, pushing down growth-sensitive sectors in particular. Except for the energy space, which emerged as a major beneficiary from the war-triggered power crisis, all sectors showed negative returns. On a regional level price gains were very limited to only a few markets, such as the UK.

In the first part of this Sound Invest issue, we analyze 2022 in more detail and put investment returns in a historical context. In the second part, despite currently low visibility, we show where investors need to look for opportunities and how we are positioning ourselves for the coming year.

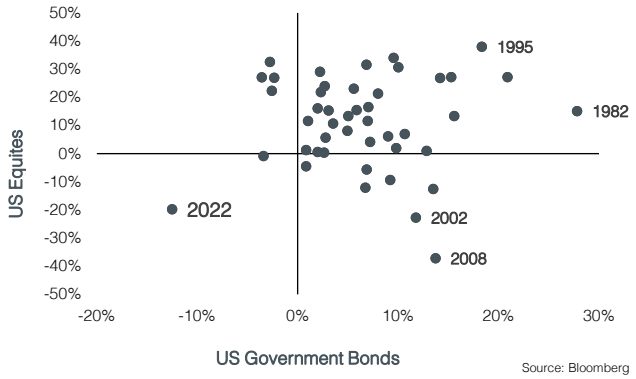
Asset Returns in 2022



Sound Capital Asset Allocation 2022

Fixed Income

A look at the two major investment categories, equities and bonds, shows just how extraordinary investment returns were in 2022. Never in the last 50 years has there been a year in which both areas suffered comparably. Historically, government bonds have served as a safe haven when stock markets were in turmoil. As shown in the chart below, the dotcom bubble (2002) and the global financial crisis (2008) are good examples of the usually negative correlation of equities and bonds.

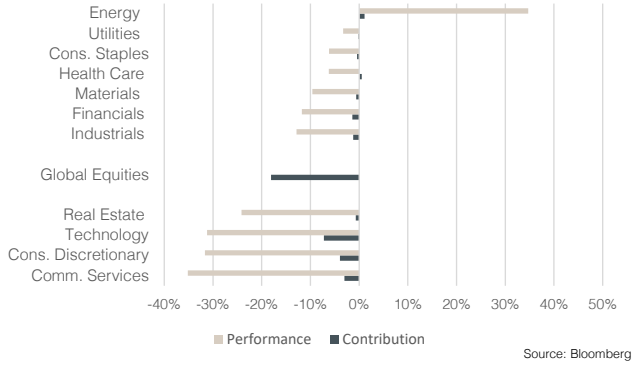


The combination of double-digit negative returns on bonds and equities led to the most negative returns in over 100 years, especially for balanced strategies. The reason for the unusual losses in the bond market probably reveals the biggest mistake investors made in 2022. At the beginning of the year, market participants expected a turnaround in monetary policy, but massively underestimated the dynamics of inflation. For 2022, the market expected three interest rate hikes by the Fed to bring rates back to 0.75%, while only a single interest rate hike to still negative -0.4% was expected from the ECB. The reality was vastly different: Extraordinarily large interest rate hikes by the Fed brought rates back to 4.25% and the tightened rates back to 2%, which was significantly higher than expected. It is worthwhile mentioning that major central banks started the tightening path from zero or even negative interest rates. As a result, there was an extreme base effect, causing the largest percentage interest rate increase in the history of financial markets.

At the beginning of the year, we started with an underweight position in bonds with a focus on short maturities, under-weighting government bonds. This was a good decision in relative terms, however in absolute terms, there were no profitable areas in the fixed income space. Thus, we had correctly assessed the direction, but significantly under-estimated the extent of interest rate shifts. Attractive yields in emerging markets could not compensate investors sufficiently, mainly due to developments in China (real estate crisis, covid lock-down). Over the course of the year, higher interest rates and rising credit spreads led to a neutral and, by the end of the year, overweight positioning in fixed income investments. Our underweight in government bonds was gradually reduced. We kept a clear focus on quality and avoided the riskier areas of the fixed income market. We also took account of regional differences in monetary policy. The Fed reacted more quickly and more specifically to high inflation, while Europe still has some catching up to do in this respect.

Equities

Rising interest rates also set the tone for equities last year. One can certainly point at a fundamental change or a regime shift. Years of zero interest rate policy and increasingly offensive investors were supported by a gigantic increase in liquidity. Over the past few years, this has boosted fast-growing sectors such as technology, communications and consumer cyclicals. With the technology sector accounting for almost a quarter of global equity capitalization at the beginning of the year, the most interest rate sensitive part of the equity space came under heavy pressure. About 40% of last year's losses can be attributed to the technology sector. Adding the cyclical consumer goods and communications sectors, the weakest areas have accounted for about 80% of the negative total equity market returns in 2022. Very similar to 2021, 30% of global equity returns came from just 6 US companies (Alphabet, Apple, Meta, Microsoft, Nvidia, Tesla), but with a negative contribution this time. The energy sector was able to gain massively with almost 35%, but represents just about 3% of global market capitalisation and thus contributed only 1.1% to worldwide equity returns.



We started the year with a neutral equity positioning and remained neutral until mid-December. Like many investors, we were caught off guard at the beginning of the year by the shattering outbreak of war in Eastern Europe. The resulting bottlenecks in global supply chains and the surge in inflation induced a shift towards a more defensive equity allocation. At the end of the year, we implemented an equity underweight, triggered by very low equity risk premiums and improved sentiment as shown by our contrarian risk index.

Alternative Investments

While double-digit negative returns were almost inevitable in the major investment categories, alternative investments were able to serve their purpose in portfolios very well. We started the year with an overweight and a focus on non-correlated investments, one of the few areas where positive returns were possible this year. The positive diversification effect of a solid selection of alternative investments is mainly reflected in lower volatility of portfolios. However, the high interest rates in USD and GBP capital markets mean that attractive returns can now be achieved again risk-free investments. For this reason, the overweighting of alternative investments was reduced in favor of bonds towards the end of the year.

Outlook 2023

Fixed Income

- Positive money market returns
- Focus on high quality issuers
- Gradual increase of duration risk
- Volatility provides opportunities

The good news first: statistics point to a positive year 2023, especially in the US. Since the beginning of common data recording, there have only been three situations in which a negative year for treasuries was followed by further losses in the subsequent year: 1955-56, 1958-59 and now 2021-22. Statistically there have never been three consecutive yearly losses.

Positive interest-bearing money market investments also have a supporting effect. Risk-free rates in EUR, CHF, USD and GBP are at their highest level since 2008. This is another example of a regime change, as some investors were even facing negative interest rates until only a few months ago. In addition, the general rise in interest rates means that investors in all asset classes are being much better compensated for potential risks.

Although the central banks have not yet fully completed the tightening of monetary policy, the size and number of interest rate hikes in the coming 12 months is likely to be significantly lower than last year. In this respect, the ECB will probably need to catch up with the Fed. There is reason to believe that the macroeconomic effects of higher interest rates will only start to unfold in 2023. Central banks are still forced to tighten monetary policy due to inflation. It seems plausible that an end or even a turnaround in interest rate hikes is only possible when there are clear signs of normalizing inflation. This may not be the case until there is a sharp decline in economic output or even a recession. Hence, it would not be surprising if this tightening cycle were to last longer than necessary. “From inflation to recession” is thus a likely scenario for the coming year. This is already reflected by the inverted yield curves, which in the past have almost always been followed by positive returns for high-quality bonds.

Another positive aspect for the bond market is observed when looking at maturities. Over the coming year, there will be relatively little need for global refinancing, which means that few companies will be forced to raise money at higher interest rates, especially in the high-yield segment. This is probably one of the reasons why high yield credit spreads are remaining at very low levels despite the gloomy outlook.

We maintain overweight in USD and GBP bonds and a neutral weighting in CHF and EUR bonds for the current year. We will use new highs in European interest rates to gradually increase maturities of high-quality borrowers.

Equities

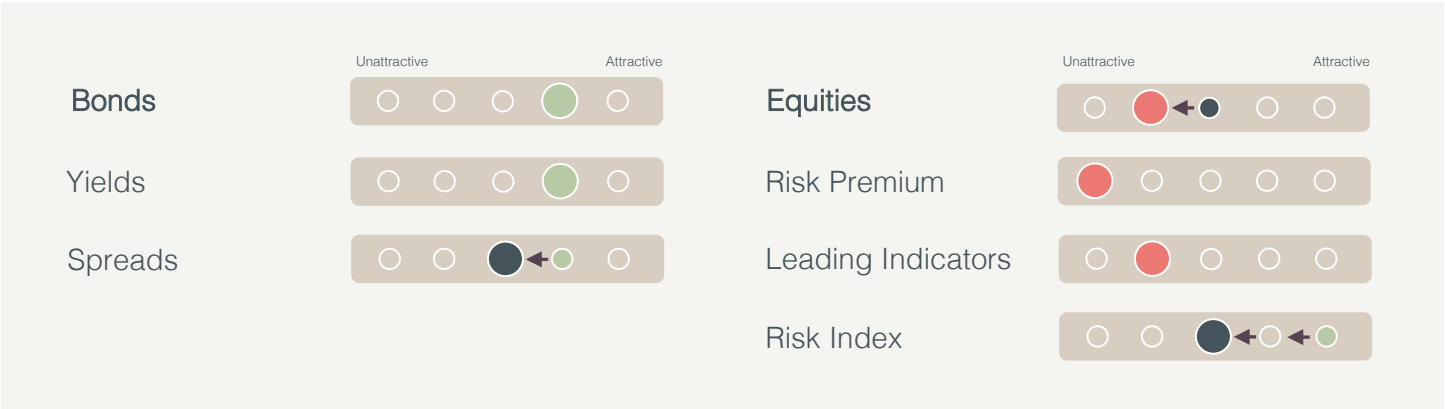
- Unattractive equity risk premium
- Normalized valuations
- Overweight defensive inflation beneficiaries
- Active management is key

With the increasing probability of a US recession combined with unattractive equity risk premiums, caution and careful selection in the equity space are warranted. The normalization of high valuations of the growth sector, which has been established over several years of extremely loose monetary policy, is likely to continue given the still ongoing tightening of monetary policy.

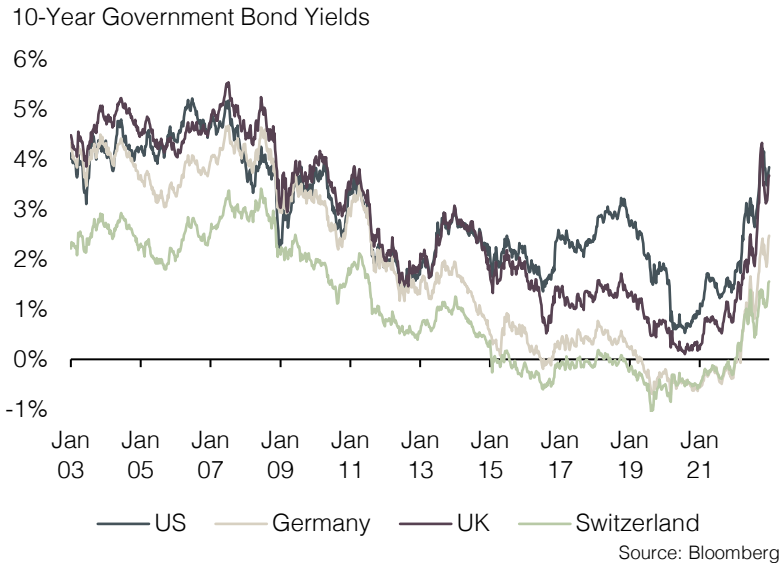
In our view, however, it is not enough to split the equity universe into "value" and "growth" companies. What is much more important is a clear focus on quality, intrinsic value, and sustainable growth. Even in times of high inflation, there are companies that emerge as winners due to their solid market position. In general, investors need to keep in mind that equities are real assets that offer good inflation protection in the long run.

We started the year with an underweight in equities and have kept a defensive bias. Accordingly, we have favored the Swiss equity market regionally, which brings the benefits of lower volatility as well as a safe currency in times of market stress. From a sector perspective, we have favored healthcare, which offers decent protection against inflation as well as solid returns that are less dependent on the economic cycle. Furthermore, we have focused on high quality stocks with attractive dividend yields. These stocks tend to generate continuous cash flows throughout the economic cycle and are less vulnerable to an economic downturn.

In our view, the average expected price target for the global market (where analysts see 20% upside potential) for the next 12 months is too optimistic. Several backtests confirm that these estimates lag in a procyclical way. Nevertheless, it should be mentioned that positive surprises are certainly possible in the current environment. For example, a resolution to the war situation in Eastern Europe or the complete and a full sustained opening of China would probably boost risk assets. A faster decline of inflation and thus a more rapid end to monetary tightening could also trigger a jump in share prices. In equities, as well as in fixed income, statistics point to a positive return in 2023. Historically, with few exceptions; double-digit negative returns were often followed by positive subsequent years. The coming year will reveal how successful the implementation of monetary policy has been with regards to fighting inflation. We see a challenging first half of the year, in which visibility regarding inflation and economic development should improve. This phase of high uncertainty is likely to offer the greatest opportunities in the coming months.



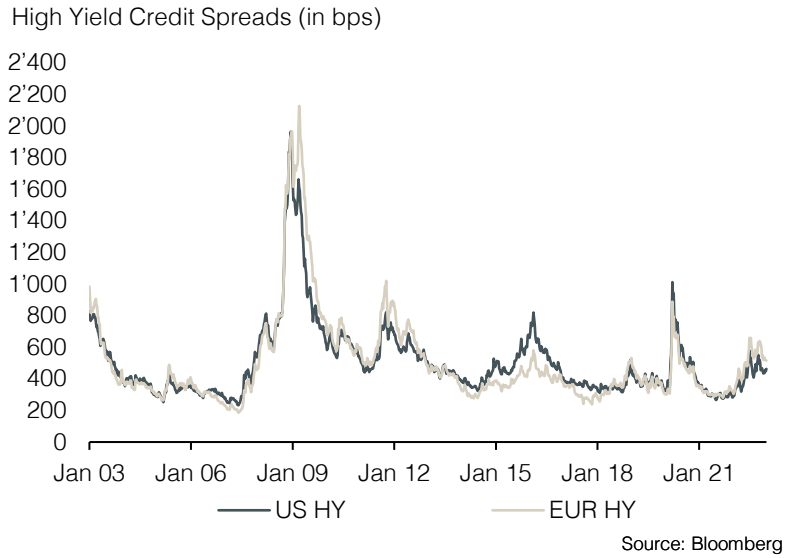
Yields



View:

The year 2023 will start with the highest nominal yields in more than 10 years. Even after deducting expected inflation, interest rate levels appear historically attractive. However, there are still clear regional differences. While in the US the Fed has reacted stronger and faster to inflation, European central banks are still behind the curve. Hence, it does not come as a surprise that 10-year bond yields in the US already peaked last October, while in Europe the peak is likely yet to come.

Spreads



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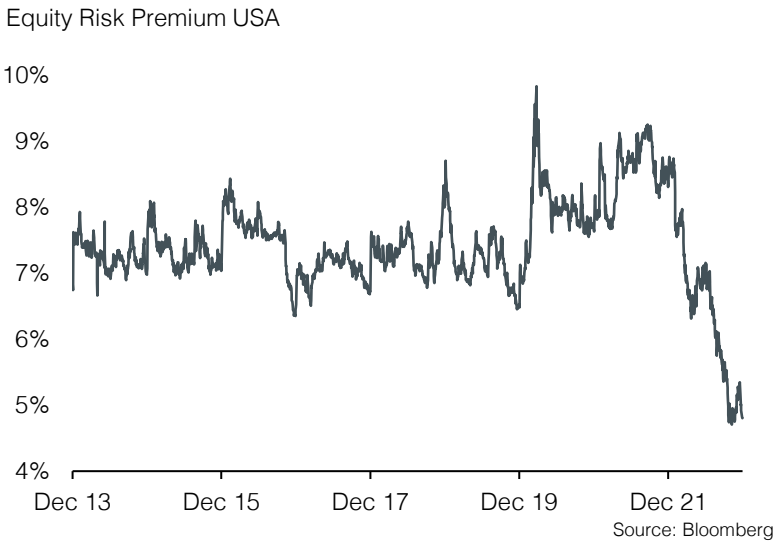
Unlike the leading economic indicators, which increasingly point to a global downturn, credit spreads for corporate bonds have fallen in almost all areas. Our assessment has been downgraded accordingly from attractive to neutral. We urge caution regarding credit risks and avoid high-yield bonds. However, the high volatility in the bond markets is likely to bring opportunities over the coming months.

Equity Risk Premium



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Over the past few weeks, the equity risk premium has fallen again and remains in strongly negative territory. Falling growth expectations will face a reality check starting January as the publication of quarterly results will show how companies are coping with the changing interest rate landscape.

Leading Indicators

According to the assessment of renowned analysts, the probability of a US recession over the next 12 months is at 65%. At the beginning of the year, the same figure was at 15%. Except for the labor market, which as a lagging indicator hardly serves as a forecasting tool, most indicators show a negative trend. We maintain a negative assessment.

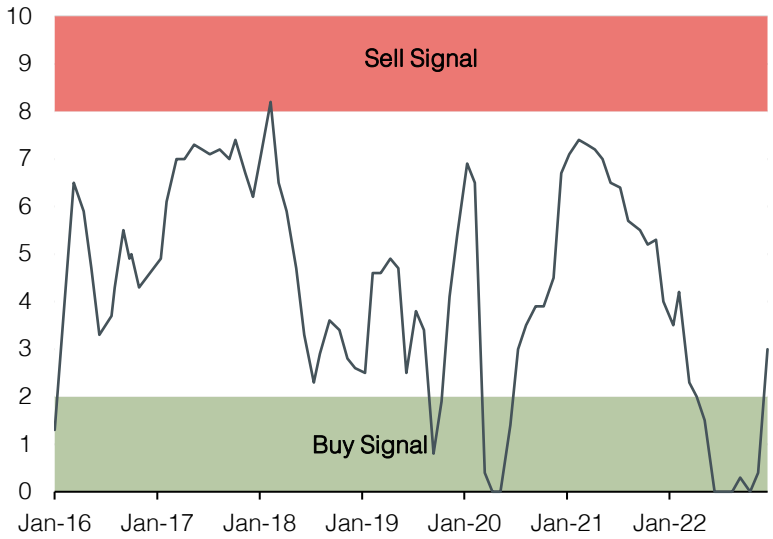
View:

Services PMI

	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	Nov 22	Dec 22	Jan 23
Multi-national	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	49.2	48.1		
United States	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	47.8	46.2	44.4	
Eurozone	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	48.6	48.5	49.1	
Germany	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	46.5	46.1	49.0	
United Kingdom	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	48.8	48.8	50.0	
France	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	51.7	49.3	48.1	
Italy	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	46.4	49.5		
Spain	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	49.7	51.2		
Switzerland	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	53.6	53.5	48.4	
China Local	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	47.0	45.1	39.4	
Japan	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	53.2	50.3	51.7	

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 publication of the US inflation data, there was a real, albeit brief, spike in equity prices. In general, investor sentiment has improved over the past few weeks. For the first time in half a year, there is no contrarian buy signal from the anti-cyclical risk index. At the end of the year, this tipped the balance in favor of reducing the equity weighting from neutral to underweight.

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, Credit Suisse Research