

Sound Invest

August 2023

Longer-dated bond yields
rise

Inflation expectations
remain above target

Chinese housing-market
causes headache

Healthcare equities
preferred

China's real estate market in focus again

While the western world shines with unexpectedly positive corporate and economic data, there are signs that China's growth engine is increasingly faltering.

In August, for the fourth consecutive month, long-term USD interest rates have increased compared to the previous month. As a result, US government bonds lost ground and are now showing a negative performance since the beginning of the year. 10-year US government bond yields approached 4.35%, the highest level since 2007. A combination of positive corporate earnings and better-than-expected economic data has increased the likelihood of a soft landing for the US economy. On the other hand, the rise in long-term inflation expectations also suggests that market participants anticipate a prolonged period of inflation above the central banks' target of 2% due to robust economic growth.

The latest interest rate hikes by the Federal Reserve and the European Central Bank of 0.25% each came as no surprise. However, it's worth to highlight that the outlook for future monetary policy has remained restrictive. Nonetheless, market participants anticipate that the current interest rate cycle is completed. However, the increase in long-term interest rates also reflects that the market had anticipated lower rates prematurely. A trend that has been evident throughout the current year. Consequently, fewer interest rate cuts for the year 2024 are now being priced in.

In contrast to the past two months, fixed income market development is now leaving negative traces on stock markets as well. The equity markets are experiencing their weakest month since September 2022. Although recently released US economic data showed a strong increase in demand for durable goods, one-off effects in the aerospace sector have been the main driver, diluting the overall data set. Retail sales have also pleasantly surprised, and the labor market remains very robust. Due to higher real interest rates, the equity market risk premium has fallen even further, remaining the primary argument for a limited return potential going forward. The Chinese stock market is causing the greatest concerns for now. Chinese equities have underperformed for some time, and negative headlines are emerging continuously.

Once again, the trigger can be found in the real estate sector of the world's second-largest economy, which has been in a serious crisis for some time. Recently, the highly indebted Chinese real estate conglomerate China Evergrande filed for chapter 15 bankruptcy protection in the US due to its large debt burden, rendering it unable to meet its financial obligations. According to the rating agency S&P, more than 50 Chinese real estate developers have defaulted on payments or failed to meet their obligations in the past three years. China Evergrande is considered one of the most heavily indebted real estate companies globally, with liabilities exceeding \$300 billion. Economic measures taken by the Chinese government thus far suggest that they anticipate a longer deleveraging process and are willingly accepting the associated pain. It is not unlikely that further defaults will follow, weakening the entire Chinese economy. Although China's banking system is largely shielded from international financial markets, the already faltering Chinese economy could still have negative global repercussions.

A completely different picture emerges across the US real estate market. Despite rising interest rates, the market has surprised with sustained price increases and stable demand since the beginning of the year. Nevertheless, rising rates are increasingly kicking in: the highest mortgage rates in over 20 years stand alongside property prices that have reached historic highs. As a result, the costs of mortgage payments when buying real estate have reached their highest share of borrowers' incomes since the 1980s. It only seems a matter of time until a correction in the US real estate market occurs due to the new interest rate landscape.

Historically, such comparable housing market situations have been accompanied by a weakening economy. Therefore, we are sticking to our strategic focus and using the higher interest rates to lock in attractive yields for the longer term. Our emphasis remains on high-quality corporate bonds and government bonds. We continue to underweight equities. Within equities, we now consider the healthcare sector as attractive due to its defensive characteristics and solid growth prospects.

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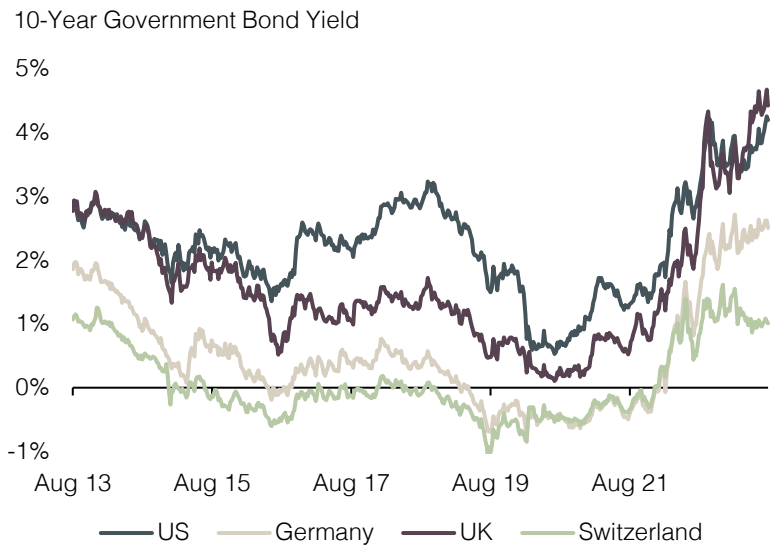
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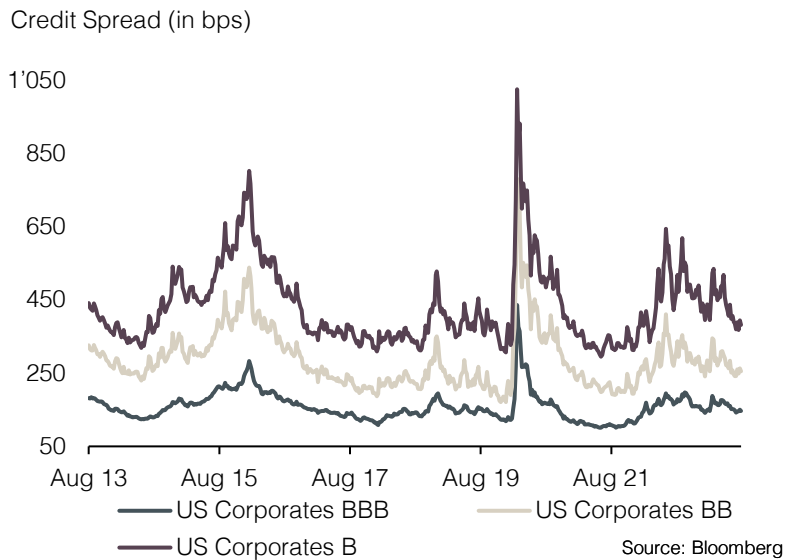
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Yields



The increase in yields for 10-year government bonds correlates closely with rising inflation expectations over the same period. We reiterate our positive view, given that yields in USD and GBP have surged to their highest levels in the past 15 years. A closer look at the expected real interest rates reveals a clear upward trend, further emphasizing their currently attractive interest rate environment. In contrast, the situation in EUR and CHF remains unchanged at a neutral level.

Spreads



Credit spreads for investment grade bonds have seen little change over the course of the past month. Conversely, there were slight declines in prices for high-yield bonds due to widening credit spreads. However, our assessment remains negative, as overall credit spreads have only marginally widened.

Equity Risk Premium

US Shiller Equity Risk Premium



View:



Higher real rates further pushed up the valuation of the US stock market. The fact that valuations look expensive from an equity risk premium point of view is also discussed among other industry publications that share our view that the stock market is currently trading at a historically unappealing level.

Leading Indicators

Unchanged PMIs in the manufacturing sector and declining PMIs in the service sector confirm our last month's assumption that a convergence of the purchasing manager indices is likely. Particularly noteworthy are the significantly lower prints in Europe within the manufacturing sector. These are also linked to a decelerating growth in China.

View:



Manufacturing PMI

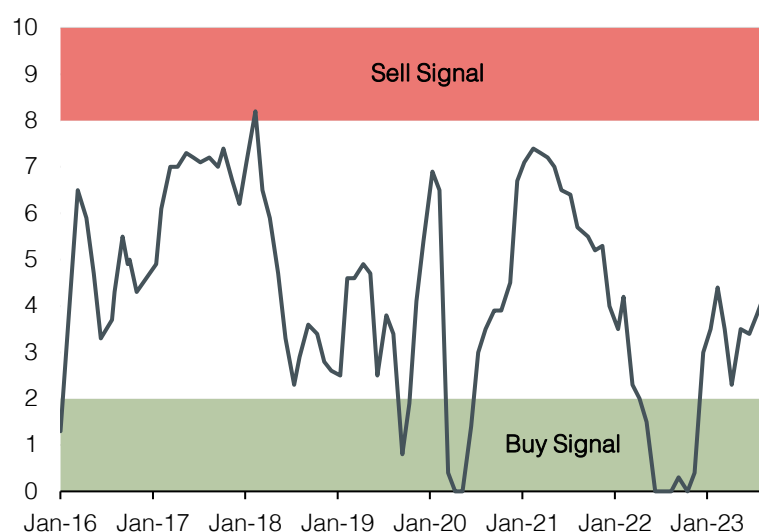
	Nov 21	Dec 21	Jan 22	Feb 22	Mar 22	Apr 22	May 22	Jun 22	Jul 22	Aug 22	Sep 22	Oct 22	Nov 22	Dec 22	Jan 23	Feb 23	Mar 23	Apr 23	May 23	Jun 23	Jul 23	Aug 23
Global	54.2	54.3	53.2	53.7	53.0	52.3	52.4	52.2	51.1	50.3	49.8	49.4	48.8	48.7	49.1	49.9	49.6	49.5	48.7	48.7		
USA ISM	60.8	58.6	57.6	58.4	57.0	55.9	56.1	53.1	52.7	52.9	51.0	50.0	49.0	48.4	47.4	47.7	46.3	47.1	46.9	46.0	46.4	
Europe	58.4	58.0	58.7	58.2	56.5	55.5	54.6	52.1	49.8	49.6	48.4	46.4	47.1	47.8	48.8	48.5	47.3	45.8	44.8	43.4	42.7	43.7
United Kingdom	58.1	57.9	57.3	58.0	55.2	55.8	54.6	52.8	52.1	47.3	48.4	46.2	46.5	45.3	47.0	49.3	47.9	47.8	47.1	46.5	45.3	42.5
Switzerland	64.1	64.5	63.7	62.7	63.3	61.6	59.8	59.1	58.0	56.7	56.8	55.4	54.4	54.5	49.3	48.9	47.0	45.3	43.2	44.9	38.5	
China Local	50.1	50.3	50.1	50.2	49.5	47.4	49.6	50.2	49.0	49.4	50.1	49.2	48.0	47.0	50.1	52.6	51.9	49.2	48.8	49.0	49.3	
Japan	54.5	54.3	55.4	52.7	54.1	53.5	53.3	52.7	52.1	51.5	50.8	50.7	49.0	48.9	48.9	47.7	49.2	49.5	50.6	49.8	49.6	49.7

Services PMI

	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	Feb 23	Mar 23	Apr 23	May 23	Jun 23	Jul 23	Aug 23
Global	55.6	54.7	51.0	54.0	53.4	52.2	51.9	53.8	51.1	49.2	50.0	49.2	48.1	48.1	50.1	52.6	54.4	55.4	55.5	53.9	52.7	
USA ISM	67.6	61.7	60.4	57.2	58.4	57.5	56.4	56.0	56.4	56.1	55.9	54.5	55.5	49.2	55.2	55.1	51.2	51.9	50.3	53.9	52.7	
Eurozone	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	49.8	50.8	52.7	55.0	56.2	55.1	52.0	50.9	48.3
United Kingdom	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	49.9	48.7	53.5	52.9	55.9	55.2	53.7	51.5	48.7
Switzerland	59.2	59.9	56.4	64.3	61.1	56.2	59.6	58.1	55.6	56.6	52.8	53.8	53.4	49.5	56.7	55.3	54.2	52.2	52.6	49.6	42.7	
China Local	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	54.0	55.6	56.9	55.1	53.8	52.8	51.5	
Japan	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	51.1	52.3	54.0	55.0	55.4	55.9	54.0	53.8	54.3

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:



Despite an upward trend, the risk index remains neutral. Investor sentiment has significantly improved since the beginning of the year; however, many investors still maintain high cash holdings.

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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