WYSS & PARTNER

Review of Financial Markets Q3 2022

Financial markets managed to recover from the June lows initially, but ultimately the downward trend continued. Major concerns about global inflation, energy security, the war in Ukraine and the general well-being of the world economy have not eased, raising investor uncertainty to the highest levels. Contrary to the entrenched belief that asset diversification can limit the damage, this strategy has not worked this year. In particular, bonds have suffered an enormous loss in value, and has consequently not been able to cushion the decline in the value of equities. The Bloomberg Index for a mixed portfolio structure of 60% equities and 40% bonds was down 21 % at the end of the quarter (see chart 1).

One of the key challenges is to combat the unusually and stubbornly high inflation rates without plunging the economy into a (deep) recession. Opinions differ on this: while for some, interest rates have been tightened far too fast and too violently, for others, rates need to rise much higher to eradicate the inflation virus. If the U.S. central bank stays on the interest rate path it has mapped out, a recession in the U.S. cannot be ruled out. Should the inflation figures weaken significantly in the foreseeable future, the market (forward curve of the Fed Funds) could be right that the interest rate peak will be reached at the beginning of 2023. Under these circumstances, one can hope for less severe damage to the economy.

In Europe, the economic situation is delicate and tense due to the war in Ukraine and its fallout throughout the continent. Various indicators suggest that at least parts of the EU are already in recession. With double-digit inflation rates, the ECB has no choice but to raise interest rates to avoid losing credibility as the bloc's monetary authority. Numerous government programs amounting to some 600 billion euros have been announced to help citizens and companies with energy costs.
China, unlike almost all other nations, has left COVID restrictions in place, which is estimated to cost the country 3 to 4% in economic growth. In addition, the real estate industry is in a prolonged crisis, which is aggravated by the demographic development. It remains to be seen whether the economic pressure will lead to a departure from the zero-tolerance policy.

The war in Ukraine could continue for a long time if the West is not willing to seek a political/diplomatic solution. Military confrontation, in any case, cannot bring a solution, as both parties hold the apocalypse in their hands. With the continuation of sanctions, at least Europe will have become more independent in terms of energy supply, even if energy costs remain higher as a result. Other conflicts, such as the dispute over Taiwan's independence, also contribute to shattering geopolitical stability.

These conditions are also the cause of overwhelming pessimism in the financial sector and among private investors. However, it is in financial markets' nature to assess the future rather than the present. At present, the bond markets have probably come to terms with the tighter monetary policy and high inflation rates. The stock markets have adjusted to the higher interest rate levels and have planned for a weakening of profits. However, there is no recession built into prices in either asset class.

The rest of the year will be shaped by the assessment of the risk of recession and the restrictiveness of the required monetary policy. A significant drop in inflation rates would ease interest rate expectations and reduce the extreme risk aversion.

Chart 1: Gross return Q3 2022 in USD for different asset classes (in %)

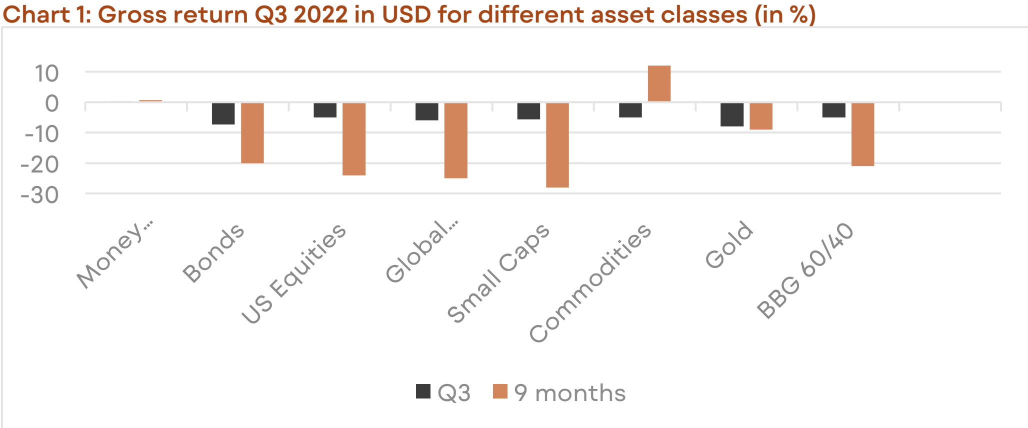
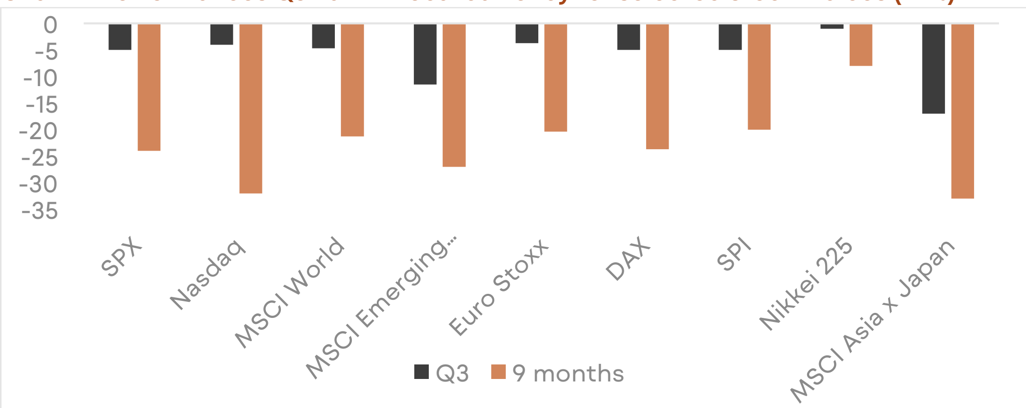


Chart 2: Performances Q3 2022 in local currency for selected stock indices (in %)



Wangs, 5.10.2022