WYSS & PARTNER

Investment Policy 2024

Monetary policy pivot and economic slowdown

- Global economy barely recovers
- Recession still possible in the USA and Europe, but then rather mild
- Declining inflation - easing financial conditions
- Money market and bonds with attractive return potential
- Equities caught between lower interest rates and recession risks

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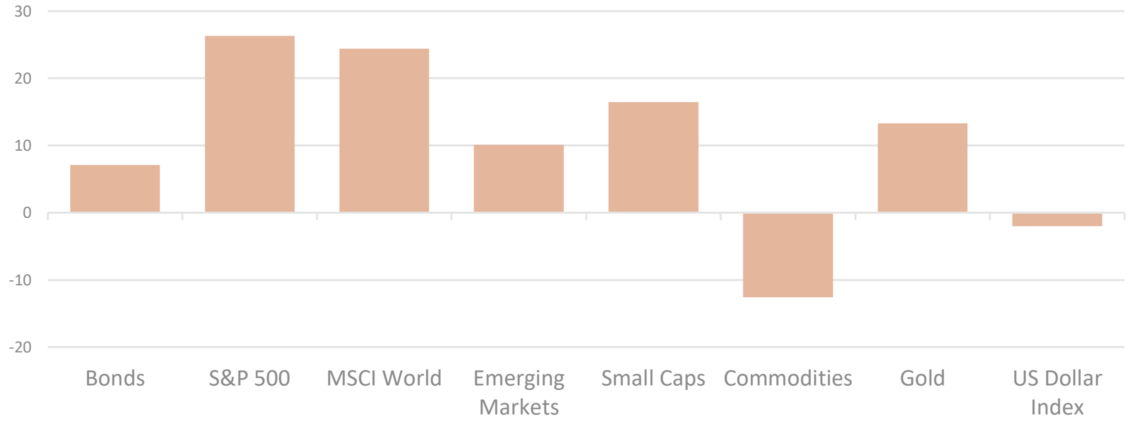
Review 2023

Chart 1: Performances in USD

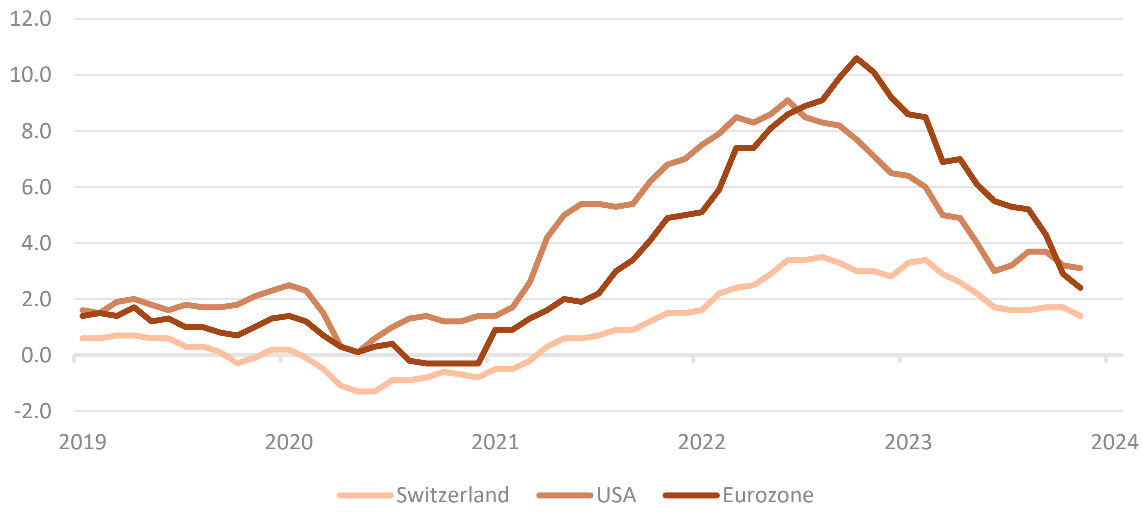


Source: Bloomberg

At the beginning of 2023, the prevailing opinion in markets was that the USA and Europe were highly likely to fall into recession. By the end of the year, many observers were rubbing their eyes in disbelief at the lack of economic contraction, continued strong employment, and early successes on the inflation front. The economic resilience was even more surprising as the central banks continued to raise interest rates well into 2023. For the time being, the assessment of the unparalleled monetary tightening was positive. US

regional banks suffered notable collateral damage from the tight interest rate policy, but this did not dissuade the Fed from its course, especially as the crisis was kept in check. The downfall of Credit Suisse could not be prevented, as the crisis of confidence could not be reversed. With the integration into UBS, a market-oriented solution was found and a tremor on the international financial markets was prevented. Political developments and events, such as the war in Gaza, had limited impact on global financial markets. AI, led by the poster child ChatGPT, was a catalyst for a stellar performance of shares involved in the topic of genetic artificial intelligence.
Reversing the disaster of 2022, the IT sector was the strongest performer with a gain of over 50%. Nvidia, market leader in semiconductors for AI processing, was a standout among AI beneficiaries. Its shares tripled, catapulting the company's market value to over USD 1 trillion. In the broader equity market, performances of the individual sectors varied greatly. Defensive consumer stocks, the healthcare sector and utility stocks barely increased in value. In addition to the IT sector, cyclical consumption and communication stocks achieved an above-average performance. The global index rose 24%, strongly supported by the US market, which gained 26%; the performance of the European index was similarly strong. Given the sectoral composition of the index (pharmaceuticals, food), Switzerland lagged well behind. The Asian markets, particularly China, also posted weak performances, while Japan was able to post a strong performance on the back of a historically weak Yen.

Chart 2: Inflation (in %)



Source: Bloomberg

The yield on 10-year US government bonds rose over the course of the year to 5%, only to fall back to the starting level by the end of the year. With falling risk premia, respectable returns were generated in a USD bond portfolio. The yield on 10-year Swiss government bonds fell from 1.6% to 0.7%, also resulting in a positive effect on the performance of bond portfolios.

Contrary to widespread expectations, the USD remained stable on a trade-weighted basis, although it lost 3% against the euro and a considerable 9% against the CHF. The Swiss franc appreciated by around 5% in real terms, burdening Switzerland's export-heavy economy. Commodities lost over 10 %, with falling energy prices shouldering most of the blame. Industrial metals were also weak, while the picture for precious metals was mixed. Gold was able to gain over 10%, supported by plummeting real interest rates in the last quarter of the year.

Outlook 2024

2024 will show whether the initial success of monetary policy tightening will become a more permanent success. At the turn of the year, the consensus is that global economic growth will continue to be below average in 2024 and that growth is driven from economies in Asia. However, the risk of a recession is considered to be significantly lower than 12 months ago. Lower inflation rates should, at the very least, be maintained, if not improved. From the current point of view, the cycle of rising interest rates has come to an end and a long-awaited pivot to lower central bank rates will be getting underway in 2024. Accordingly, the fireworks in equities at the end of 2023 were not just of a technical nature, but an anticipation of better (than expected) conditions in 2024. The OECD forecasts published at the end of November (see chart 3) illustrate the picture of subdued, but still positive, economic development. The geopolitical hotspots have hardly changed. The marking and defense of (geographical) spheres of interest in a multipolar world clearly brings potential for conflict with it. One notable example is Taiwan, where Western economic interests collide with Beijing's political ambitions. The parliamentary and presidential elections in the USA will probably be the main topic in the media, but their impact on geopolitics is likely to be minor. The war in Gaza has the potential to become a regional conflict with, among others, serious consequences for the supply of the global economy.

Chart 3: Growth projections OECD

	2023		2024		2025
World	2.9	▬	2.7	▬	3.0
OECD	1.7	▲	1.4	▬	1.8
Australia	1.9	▬	1.4	▬	2.1
Canada	1.2	▬	0.8	▼	1.9
Euro area	0.6	▼	0.9	▼	1.5
Germany	-0.1	▬	0.6	▼	1.2
France	0.9	▬	0.8	▼	1.2
Italy	0.7	▼	0.7	▼	1.2
Spain	2.4	▲	1.4	▼	2.0
Japan	1.7	▲	1.0	▬	1.2
Korea	1.4	▬	2.3	▬	2.1
United Kingdom	0.5	▬	0.7	▼	1.2
United States	2.4	▲	1.5	▲	1.7

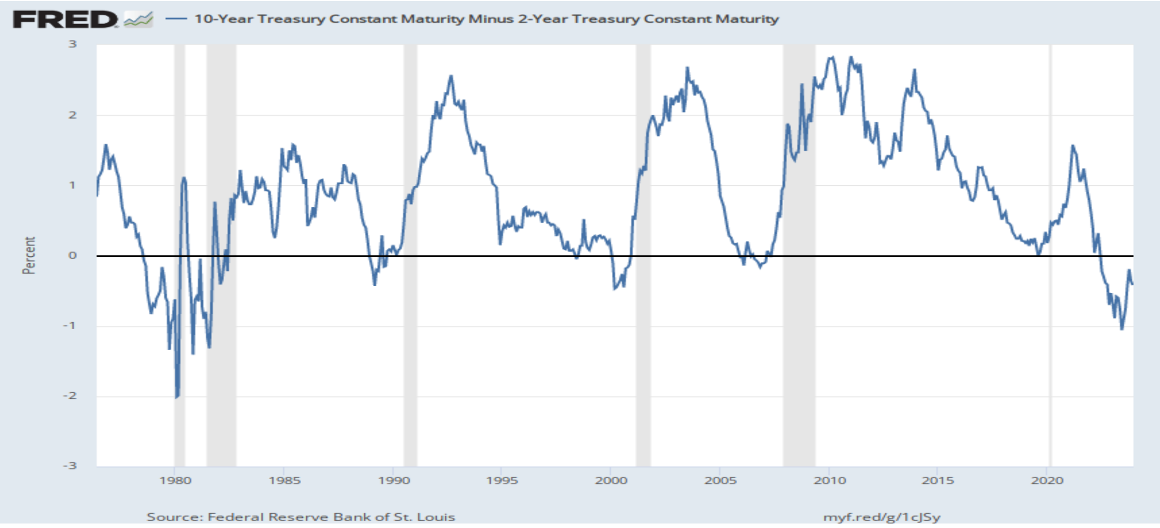
	2023		2024		2025
G20	3.1	▲	2.8	▬	3.0
Argentina	-1.8	▬	-1.3	▼	1.9
Brazil	3.0	▲	1.8	▲	2.0
China	5.2	▬	4.7	▼	4.2
India	6.3	▬	6.1	▼	6.5
Indonesia	4.9	▬	5.2	▬	5.2
Mexico	3.4	▲	2.5	▲	2.0
Russia	1.3	▲	1.1	▲	1.0
Saudi Arabia	-0.4	▼	3.0	▼	4.7
South Africa	0.7	▲	1.0	▬	1.2
Türkiye	4.5	▲	2.9	▼	3.2

▬ no forecast change / smaller than 0.3%   ▲ ▼ change in forecast > 0.3% / < -0.3%

Economic Outlook

The surprising resilience of the economy in 2023 is largely due to the consumer, who, in light of the good employment situation and rising wages, primarily fueled consumption of services (travel, etc.). In the USA, savings accumulated during the pandemic continued to be put back into the economy through spending. We doubt that the US economy and consumer will remain equally resilient in 2024. In any case, it would be the first time that a tightening of monetary policy with an accompanying inverse interest rate structure would come to pass without a following slowdown. This is illustrated by chart 4, which shows that whenever there has been a phase in which the 2-year yield was higher than the 10-year yield on US government bonds, sooner or later a recession occurred. We would at least question whether this time can be different.

Chart 4: US yield curve and economic growth



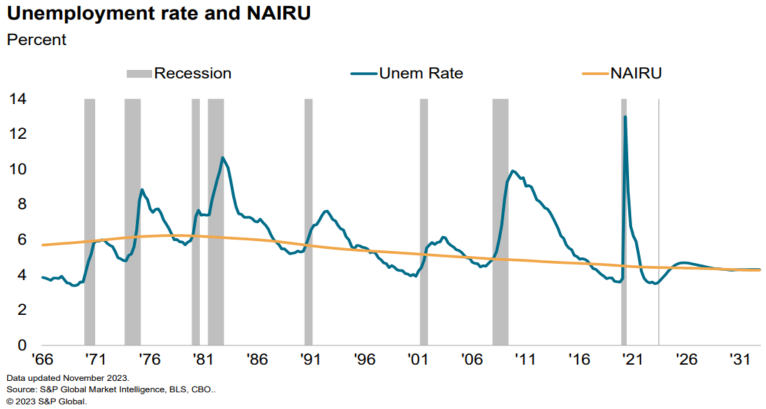
Source: Federal Reserve Bank of St Louis (grey areas denote recessionary periods)

In addition, signals from the labor market (see chart 5) support the expectation of a recession. In the past at least, when the labor market tightened significantly and the unemployment rate fell below the level that keeps inflation in check (yellow line in chart 5), a recession has followed.

This leads to the conclusion that the US Federal Reserve is very likely to change its monetary policy and reduce the commitment and intensity of pursuing the target inflation of 2%. A satisfactory economic situation is of eminent importance for the re-election of the President. A possible fiscal policy injection to secure growth and Biden's re-election can be ruled out, as the Republicans in Congress would vote against it for obvious reasons. As things stand today, the election campaign in the US will be between Biden and Trump. According to the polls, it could be a close call. Numerous forces in the USA are currently focused on preventing a second term of Mr. Trump. In this context, it would not be surprising if the Federal Reserve were to use economically convincing arguments to embark on a faster than expected cycle of interest rate cuts.

Chart 5: US labor market and recession

US labor market and recessions



- A key risk to the base case of a sustained period of sub-potential US growth rather than a recession relates to the current exceptionally low level of the unemployment rate.
- Securing a 'soft landing from below' has historically proved very difficult to achieve.
- Whenever the unemployment rate in the US has run well below the NAIRU (Non-Accelerating Inflation Rate of Unemployment) for a sustained period, monetary policy tightening cycles have invariably led to recessions.

Source: S&P Global Market Intelligence

Europe's situation is likely to turn slightly better, with the help of savings from the pandemic, which should flow into consumption, a gradual recovery of the industrial complex, government projects for the energy transition and a supposed slight improvement in the Chinese economy. It is also expected that the ECB will follow an interest rate cut in the USA, thereby easing monetary conditions somewhat.

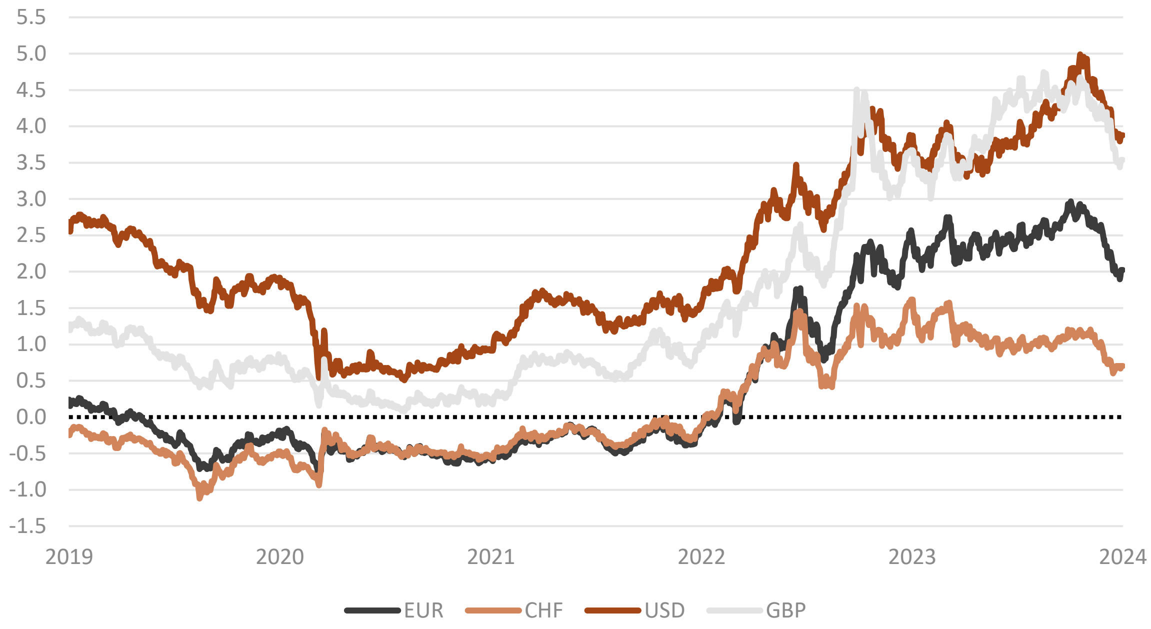
China is facing several structural difficulties, be it the property market, demographic trends, or the flight of foreign producers, i.e. capital. As these problems cannot be solved with any short-term measures, but have an inhibiting effect on growth, the Chinese economy is likely to remain below its potential.

Capital markets – some relief expected

Towards the end of the year, the bond markets began to anticipate a regime change in monetary policy. The capital market will benefit from the foreseeable – although uncertain in terms of timing and magnitude – easing of interest rates, although the potential is limited with a lot of anticipation already reflected in market prices. This process also depends largely on the extent of the improvement on the inflation front and long-term inflation expectations. As the latter have remained relatively stable, the easing of monetary policy is likely to move shorter maturities in particular, leading to a normalization of the yield curve.

As US yields set the tone globally for the directional trend, yields in EUR, CHF, and GBP will likely follow a similar trend. We assume that another year of positive investment returns on fixed-income securities is in the cards for 2024. In a conservative portfolio, we would emphasize medium maturities. As the recession risk cannot be ignored and credit spreads have become too low, the creditworthiness of new investments should be given high priority.

Chart 4: 10-year treasury yields



Source: Bloomberg

Currencies – signs point to a weaker USD

Forecasting currency developments is one of the most difficult endeavors in economics, as various unpredictable and random factors affect currency developments. The following statements are thus to be understood with a healthy degree of skepticism.

Due to its status as an international trading and safe-haven currency and a robust domestic economy, the USD is significantly overvalued in relation to its purchasing power. As the interest rate and growth advantage presumably declines, the US currency should come under downward pressure. This is particularly true relative to the yen, as this is where the overvaluation is most pronounced, and the interest rate differential will narrow the most. The US currency is also an anti-cyclical currency, which means that the currency is strong when the US grows faster than the rest of the world and vice versa. The presumed economic trend supports the US currency's weakness argument.

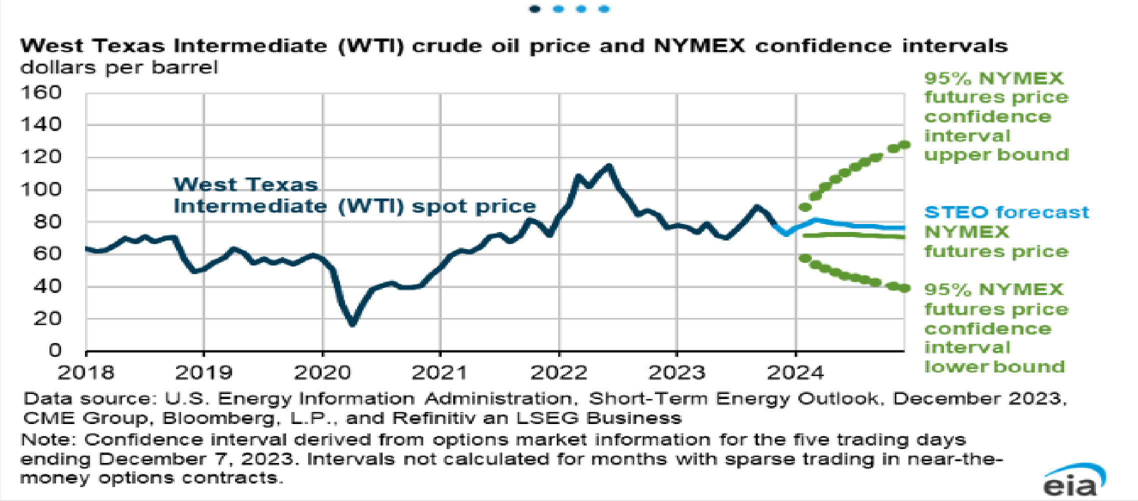
While in previous years currencies were often used as a threat and an instrument in economic conflicts, especially by the US, this has changed. We assume that the politically sensitive relationship between the Chinese and US currencies will remain relatively stable. The economic war between the two superpowers is now being fought in other areas.

With the same monetary policy orientation and lower inflation rates in Switzerland, the current trend in the CHF/EUR relationship is likely to continue. A measured weakening of the EUR will meet with little resistance from the Swiss National Bank, as the economy has learnt to live with a gradual appreciation of the Swiss franc. However, should the real appreciation be stronger, intervention by the SNB is likely.

Commodities between economic weakness and the energy transition

China's economic development is a key factor for price trends on the commodity markets. As no spectacular improvement in growth dynamics is expected in the second-largest economy and global growth remains below average, price expectations for cyclical commodities are modest. Stocks of individual products may result in price distortions, as may cartel price agreements such as those on the oil market. The US Department of Energy expects oil prices for WTI and Brent to trend sideways in 2024 (see chart 6). Precious metals become less attractive as inflation falls, which could be offset by lower interest rates and further purchases by central banks. In any case, silver and gold remain a suitable insurance policy in the portfolio.

Chart 6: Oil spot price forecast



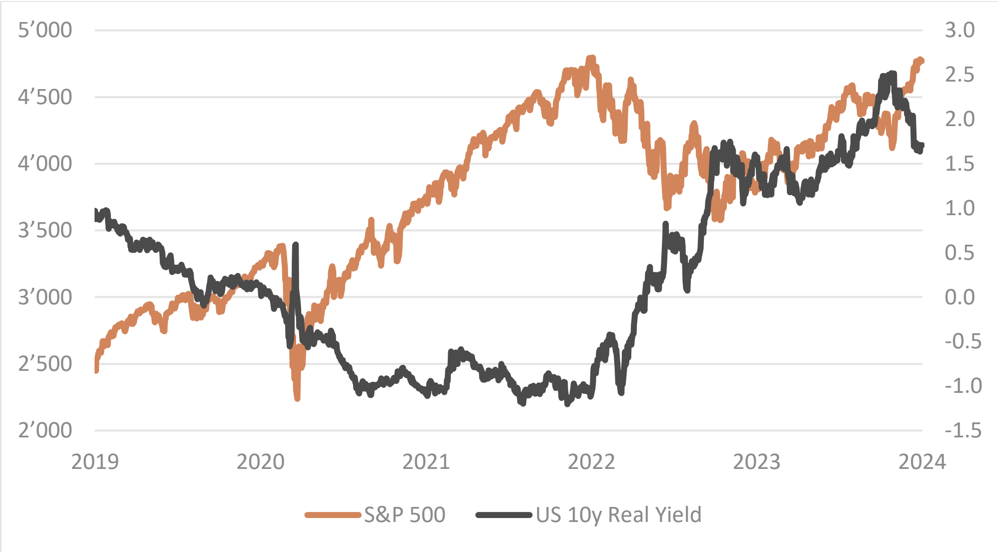
Source: EIA

Equities: Anything is possible

Interest rates and stock prices usually move in different directions, which also corresponds to economic logic. The price of a share can be envisioned as the discounted value of future earnings, so the lower the discount rate applied, the higher the price. When looking at real interest rates (nominal interest rates minus expected inflation), this correlation is even clearer. The marked rally at the end of 2023 was accompanied by falling real interest rates (see chart 9). This process could continue for a while and favor the equity market accordingly.

Earnings growth of 7% is expected for the global equity index, which seems plausible given the expected nominal growth in global GDP. The valuation of the market is below the average of the last 10 years and will therefore favor an upward trend. Should further benign economic data materialize, the potential for equities appears to be in the low double-digit range. The positive assessment of the relative valuation applies to almost all sectors with the important exception of the IT sector.

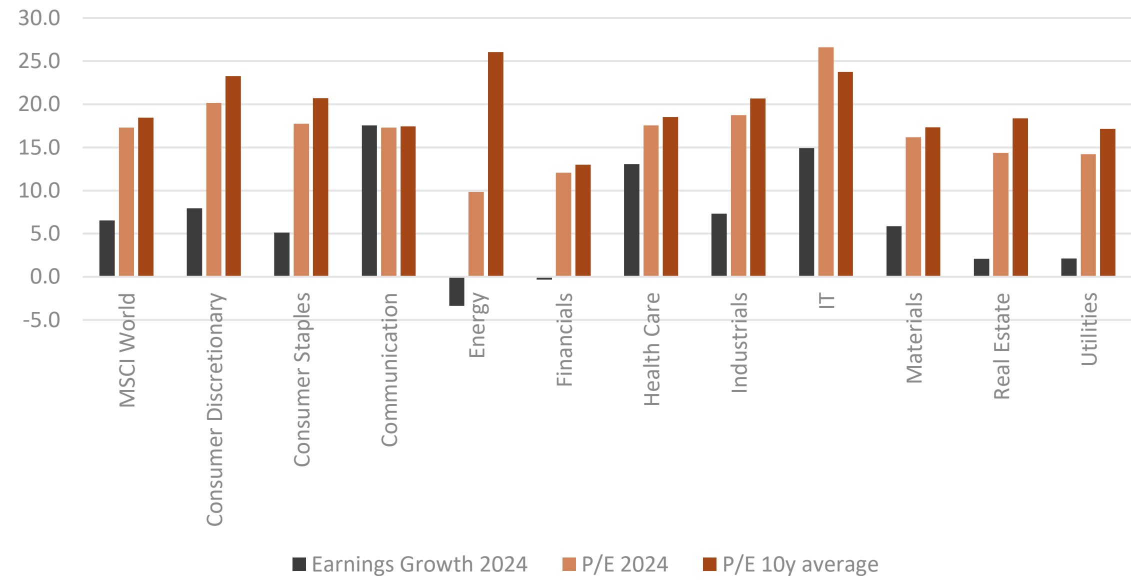
Chart 7: S&P 500 and Real Rates



Source: Bloomberg

A similarly large increase in earnings (around 15%) is expected for the communications sector, which, however, is much more attractive in terms of valuation. Irrespective of the valuation, both sectors belong in an equity portfolio, as it is difficult to imagine a positive stock market performance without the support of these sectors. Topics such as productivity and other structural trends are mainly dealt with or aided by companies in these sectors. Additionally, the healthcare sector should not be neglected, as it promises above-average growth and less demanding in terms of valuation. Modest growth and a high valuation characterize the consumer discretionary sector, which is less appealing.

Chart 8: Earnings expectations 2023 and the valuation of global sectors



Source: Bloomberg

Geographically speaking, US equities are significantly more expensive than Europe, although this will not change any time soon due to the structure of the indices. As long as a complete sector rotation does not occur, and we see little reason for this, the technology-heavy stock indices are likely to continue to lead the race, with the US market remaining in the lead. Due to the poor performance in 2023 and a slight economic improvement, China could be due for some gains and other Asian markets could follow suit.
As already indicated, there is still a risk that a soft landing will fail to materialize, and the USA and Europe will fall into at least a mild recession. In this case, earnings would be expected to fall. Chart 9 shows the index level of the S&P 500 for various earnings trends and P/E ratios. At the end of the year, the index stood at just under 4800 points and a P/E of 20. If earnings were to fall by 10%, the index would have to fall by 10% to maintain the same valuation. In that scenario however, a contraction in valuation seems more likely; if the P/E were to fall to the long-term average of 18, the index would have to correct by around 20%.

Chart 9: S&P 500 level at various earnings and valuation assumptions

	Hypothetical Change In Forward Earnings Estimate From Current Levels (%)						
Forward PE	-30	-20	-10	0	+10	+20	+30
10	1684	1924	2165	2405	2646	2886	3127
11	1852	2116	2381	2646	2910	3175	3439
12	2020	2309	2597	2886	3175	3463	3752
13	2189	2501	2814	3127	3439	3752	4065
14	2357	2694	3030	3367	3704	4041	4377
15	2525	2886	3247	3608	3968	4329	4690
16	2694	3078	3463	3848	4233	4618	5003
17	2862	3271	3680	4089	4497	4906	5315
18	3030	3463	3896	4329	4762	5195	5628
19	3199	3656	4113	4570	5027	5484	5940
20	3367	3848	4329	4810	5291	5772	6253

NOTE: AS OF DEC. 8, 2023. SOURCE: REFINITIV / IBES.

Source: BCA Research

Summary:

- Global economic growth is below average with a risk of recession in the western world. Any slump in growth will remain moderate. Globally, 2024 will be the year of the interest rate pivot.
- Inflation will continue to trend downwards, allowing central banks the opportunity to gradually lower interest rates. In the US, this process could be accelerated for political reasons.
- Bond interest rates are trending downwards. Flattening of the US yield curve, whereby we would prioritize investments in the medium maturity range.
- The US dollar is trending downwards. The Swiss franc will tend to appreciate against the euro.
- Corporate profits will rise slightly on average and a fall in real interest rates will help the equity markets to perform positively.
- The greatest uncertainty lies in the latent risk of recession with negative effects on equities and positive effects on bonds.
- The elections in the USA will attract a lot of attention, but will have little impact on financial markets, as there will likely be no dramatic change in policy, regardless of the winner's name.
- The known sources of geopolitical risk have been supplemented by the armed conflict in the Gaza Strip. If the conflict were to shake the latently unstable situation in the region, negative consequences for the global economy and markets could be expected.

Wangs, January 2024