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Market Outlook First Quarter 2023

Weak growth and high inflation

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Economy
- Inflation is set to decline only slightly gradually, forcing central banks to raise interest rates even further.
- Recessions in Europe and North America are likely, with the euro area set experience the greatest growth slump.

Financial markets
- Volatility remains high, as stock market prices do not yet fully reflect the risks to economic growth. Interest rates are likely to rise a little further.
- Selectivity is and remains crucial. Profit margins of companies with little pricing power are under the most pressure.

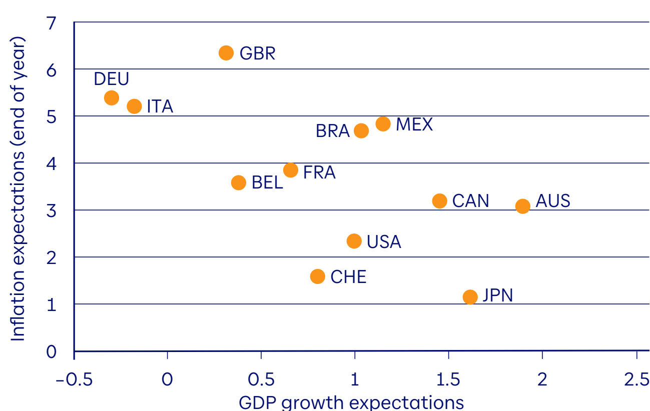
Risks
- Geopolitical risks are difficult to calculate. A further escalation of the war in Ukraine would be highly inflationary and growth-inhibiting.

World economy: Europe's stagflation

The outlook for economic growth in 2023 is gloomy. Real wages shrink because of high inflation. This will weaken demand in the medium term. At the same time, households and businesses are facing higher financing conditions. In Europe, the uncertainty surrounding the war in Ukraine and the energy crisis are further weighing on the outlook.

Leading economic indicators, such as the global purchasing managers' index, which stood at 48.2 points in December, confirm the trend towards weakening growth momentum. As a result, analysts predict an 80 per cent probability that the euro area will enter a recession in the next 12 months.

Stagflation in the euro area
IMF forecasts for 2023



Source: Baloise, Bloomberg Finance L.P., as at 09.01.2023

Inflation

We expect inflation to decline over the course of the year. However, this is likely to be only gradual, so that even at the end of 2023 inflation will still be above the central banks' targets in many places. The following three arguments justify this expectation:

- **Energy and food prices** are expected to decline due to the economic slowdown. It should be noted here that inflation would fall even if prices stabilised, as inflation is a growth figure.
- The **material and supply bottlenecks** have improved but is not yet completely resolved. In the short term, China's departure from the zero-covid policy and the resulting increase in new infections are again limiting local production capacity.
- Currently **historically low unemployment rates** in Europe and the US should prevent core inflation from collapsing rapidly.

Forecast uncertainty regarding inflation trends is high. For example, a geopolitical escalation could still push commodity prices and thus inflation up again.

As a result, significantly lower growth rates and still higher inflation are to be expected. Due to geopolitical and energy policy risks, stagflation is likely to be most noticeable in the euro area.

Figures at a glance, in percent compared to previous year

		2022	2023
Switzerland	GDP growth	2.0 %	0.6 %
	Inflation*	3.0 %	1.7 %
USA	GDP growth	1.9 %	0.3 %
	Inflation**	5.7 %	2.8 %
Eurozone	GDP growth	3.3 %	–0.1 %
	Inflation*	10.3 %	3.5 %
China	GDP growth	3.0 %	4.8 %
	Inflation*	2.1 %	2.2 %

* Year-end value. ** Measured at the consumption deflator.

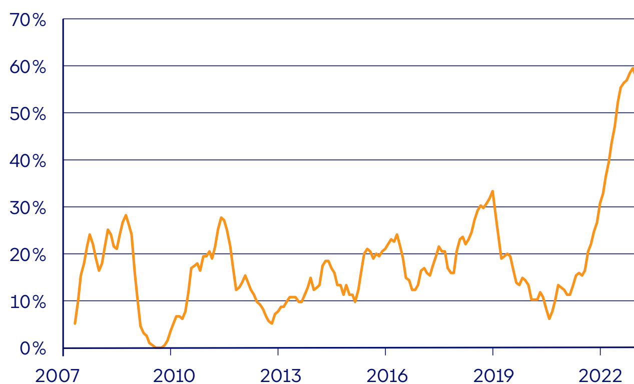
Source: Baloise, Bloomberg Finance L.P.; as at 10.01.2023

Monetary policy: Not at the end of the rate hike cycle yet

In 2022, monetary tightening occurred globally in the face of historically high inflation. In the last quarter of 2022, 38 out of 65 central banks raised their key interest rates at least once. There has not been such a regionally broad-based cycle of interest rate hikes since 2007.

Interest rate hikes

%-share of central banks that raised interest rates at least once in the last three months



Data based on 65 central banks worldwide

Source: Baloise, Bloomberg Finance L.P., as at 10.01.2023

The **Fed** raised its policy rate by 425 basis points (bps) last year. The last time interest rates were raised this much and this fast was at the beginning of the 1980s. We expect the Fed to tighten monetary policy further until a policy rate of 5.00–5.25 % is reached. The US labour market is showing signs of a gradual slowdown. The trend of additional new jobs created is declining, but still positive, and this is crucial in our eyes. Accordingly, we do not see a significant increase in the US unemployment rate in the coming months and a rapid decline in the inflation rate thus appears unrealistic.

At the same time, the Fed's balance sheet is to be further wound down. In 2022 it was already reduced by more than USD 400 billion. In relation to US GDP, however, the balance sheet is still significantly higher at 34 percent than before the pandemic (18 percent). In 2023, the balance sheet is expected to shrink by up to USD 95 bn per month.

From March 2023, the **European Central Bank** (ECB) also intends to gradually reduce its securities holdings. The redemption amounts of securities at maturity are no longer to be fully reinvested, so that by the end of the second quarter of 2023 the holdings will be reduced by an average of EUR 15 billion per month.

Interest rates, however, remain the ECB's key policy instrument. ECB chief Christine Lagarde said that to get inflation under control, the central bank "will continue to raise interest rates significantly" over the next few months. Accordingly, steady interest rate hikes can be expected in the euro area in the first half of the year.

In Switzerland, we expect the **Swiss National Bank** (SNB) to raise key interest rates in March 2023. As inflation in Switzerland is subdued by international standards, interest rates in Switzerland are likely to rise less sharply than in neighbouring countries. The SNB is also prepared to sell foreign currency if necessary.

Bonds: High refinancing costs serve a stress test

Review: At the end of 2022, interest rates once again rose significantly. The yield curve of German Bunds experienced a parallel shift of almost +60 basis points (bps) in the maturity range of 2 to 10 years. At the long end, interest rates rose only slightly more, which is why the yield curve remained flat.

The background to the rise in interest rates was not so much the ECB's key interest rate hike of a further 0.50 percentage points, which had already been expected by the market, but rather the announcement by ECB President Christine Lagarde that the end of interest rate hikes was not yet in sight.

The US Treasury yield curve remained strongly inverted at the end of the year. In 2022, interest rates at the short end shot up by more than 4 percentage points, while interest rates at the long end of the curve increased by just over 2 percentage points.

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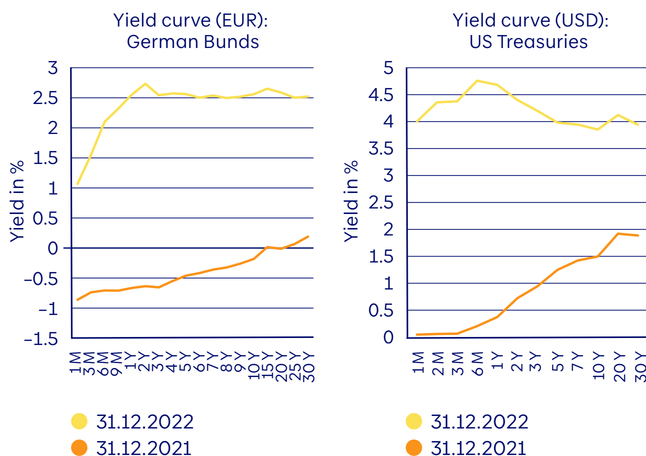
Corporate bonds saw a bear market rally in the fourth quarter. Credit spreads on investment-grade Euro corporate bonds, as measured by the Bloomberg Pan European Aggregate Corporate Index, tightened by 55 bps from the beginning of October to the end of December. USD corporate bonds of the same credit quality tightened by as much as 29 bps (Bloomberg US Aggregate Corporate Index).

Change in yield curves



Sources: Baloise, Bloomberg Finance L.P., as at 10.01.2023

Outlook: Against the backdrop of inflation rates well above the average 2 % target, we expect both the ECB and the Fed to maintain their restrictive monetary policies in 2023.

Rising energy costs will continue to weigh on inflation in the Eurozone. Europe's mild winter thus far is gradually easing the tense energy situation. For many households, however, the higher gas prices will only materialise at the beginning of the new year, as many energy suppliers were unable to adjust their prices during the year and are now doing so in January.

In view of the clear message from the central banks to stick to their restrictive monetary policy, we expect interest rates in 2023 to be significantly higher than those at which companies were able to refinance themselves in previous years. This will be a particular test for companies with low margins and high refinancing needs.

Although the level of inflation is expected to fall in 2023, it will remain at a relatively high level. Companies with little pricing power will thus experience additional pressure on their margins.

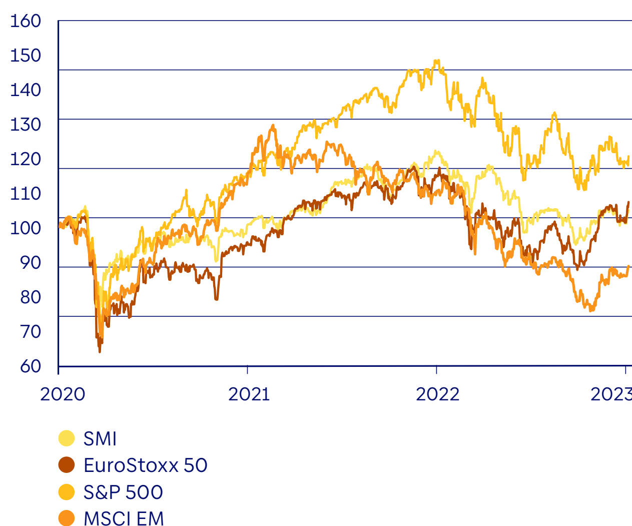
A major uncertainty factor for the development of credit spreads also remains the Ukraine war, where further escalation levels cannot be ruled out. In addition, the recent resurgence of Covid 19 cases in China could again become a stress test for international supply chains. For these reasons, we expect credit spreads to widen moderately again after the recent decline, especially for EUR bonds.

Shares: Recession priced in?

Review: The fourth quarter, like the previous quarters, was characterised by heightened volatility. Increasing investor optimism caused the MSCI World to rise by over 15 % from the beginning of October to the end of November. In December, uncertainty again spread among investors when the central banks made it clear that the fight against inflation was not yet over. Global stocks subsequently fell again by over 4 %.

At the end of the year, the annual performance of the EuroStoxx 50 was –12 % and that of the SMI –17 %. The S&P 500 and the MSCI Emerging Markets Index, where a stronger recovery was seen after the pandemic than in Europe, lost 20 % and 23 % respectively last year.

Major equity markets



Sources: Baloise, Bloomberg Finance L.P., as at 09.01.2023

Outlook: Inflation and interest rate developments are set to continue to shape sentiment in the first quarter of 2023. Expectations for corporate profits in 2023 have been revised downwards somewhat in recent months. However, in view of the recession risks and the further rise in interest rates at the beginning of 2023, it is to be feared that the current expectations are still too optimistic. Due

to a further revision of earnings expectations, we see an increased risk of a renewed price correction on the equity markets in the coming months.

Due to the interest rate turnaround, equities as an asset class have also increasingly received competition from bonds again. For the first time since 2009, the yield of global investment-grade bonds is almost 3 percentage points higher than the dividend yield of the MSCI World Index. Within equity investments, a differentiated view and selectivity in the choice of securities is key.

In a regional comparison, we prefer the Swiss equity market to other regions due to its defensive nature. In terms of sectors, the communications or IT sectors tend to be under the most pressure in the face of higher interest rates and rising recession risks. In the past, consumer staples or healthcare stocks have been more resilient in such market phases.

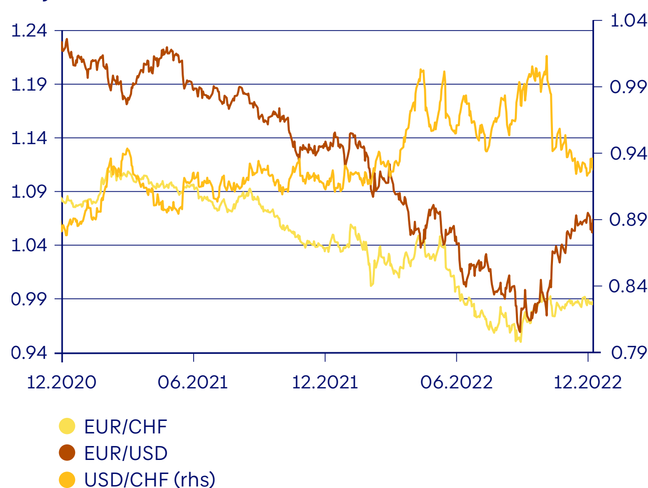
Currencies: Interest rate differentials come into play
Review: Foreign exchange movements in advanced economies were primarily determined by the varying pace of interest rate hikes by the central banks.

Thus, the strength of the US dollar dominated foreign exchange markets last year. Only towards the end of the year lost the greenback some of its value, but overall it gained more than 8% against the currencies of the most important US trading partners last year.

Among advanced economies, the Japanese yen is one of the biggest losers of the year. Unlike Western central banks, the Japanese central bank did not raise key interest rates in 2022. The Japanese Ministry of Finance even had to intervene several times to stem the slide. The sudden decision by the Bank of Japan to allow slightly higher interest rates on long-term bonds surprised investors and subsequently strengthened the yen. At the end of the year, the JPY was at 131.12 per US dollar, which still corresponds to a depreciation of 14 percent.

The euro also showed weakness last year, due to the initially rather hesitant ECB and the uncertainty surrounding energy supplies. After bottoming out in September, the euro appreciated by 9 per cent against the US dollar and by 2.3 per cent against the Swiss franc in the fourth quarter. At the end of the year, the euro was still below parity with the franc (CHF 0.98956).

Major currencies



Sources: Baloise, Bloomberg Finance L.P., as at 09.01.2023

Outlook: We believe that US-dollar strength to have peaked. Inflation in the euro area and the UK is higher than in the US. Investors therefore expect stronger rate hikes in these regions than in the US in the first half of the year.

However, the energy crisis and a possible geopolitical escalation in Ukraine pose significant risks to the euro. In this environment, the Swiss franc continues to benefit as a safe haven currency. We expect the euro-franc exchange rate to trade around parity in the first quarter.

Real Estate Switzerland
Review: On 15 December 2022, the Swiss National Bank made its third interest rate step in 2022, raising the key interest rates by +50 basis points to 1%. In 2022, there were thus cumulative interest rate steps of +175 basis points (from –0.75% to 1.0%). The latest interest rate decision had already been largely priced in by the financial markets before the decision. This can be seen from the fact that the SXI Real Estate Funds Broad Total Return Index, among others, hardly reacted significantly after the interest rate decision on 15 December 2022. The index closed the year 2022 at 440.13 points and thus with an annual performance of –15.2 %.

The interest rate trend is also increasingly noticeable in the direct real estate market. According to Fahrländer Partner (survey of eight valuation companies), the minimum discount rates for multi-family houses have been rising slowly but steadily since mid-year.

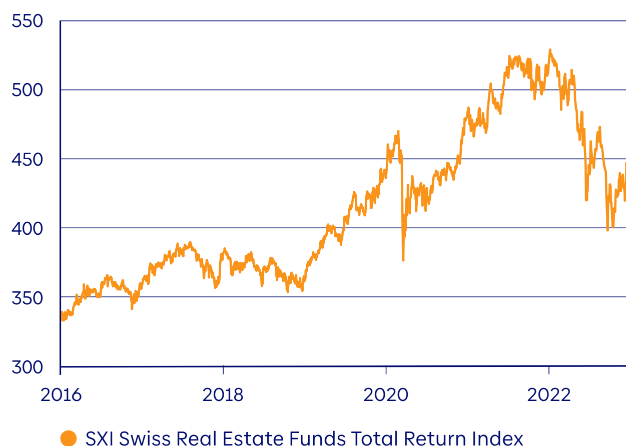
However, there are also positive signals in the Swiss real estate market, especially with regard to the demand for rental flats. On the one hand, immigration has gained significant momentum in 2022. The migration balance of the permanent resident population increased by 32.9 % or around 19,000 persons between January and November 2022 compared to the previous year, according to data from the State Secretariat for Migration SEM. Compared to Europe, Switzerland has thus recently become more attractive as a place to live and work.

Since 2012, the demand for space per inhabitant in Switzerland has increased by 1.6 m² to 46.6 m² according to the Federal Statistical Office, which corresponds to an increase of 3.6 %. In the last three years (2019 to 2021), the average living space has even increased by more than 0.5 % per year, which has a positive effect on the demand for housing.

Interest in homeownership has declined significantly since mid-2022, according to data from Realmatch360, and is back to roughly the same level as before the COVID 19 pandemic. The declining interest in homeownership is likely a result of rising interest rates. In addition, rising borrowing costs mean that the purchase of residential property for rental ("buy-to-let") has become much less attractive and is continuing to lose ground. Despite the reduced interest in home ownership, however, no negative price shifts have yet been observed. However, living in rented flats is becoming more attractive again compared to home ownership, which should have a positive effect on the demand for rented flats.

Demand for office space has also developed positively recently, because of strong employment growth as well as catch-up effects after the COVID 19 pandemic.

Swiss real estate funds



Sources: Baloise, Bloomberg Finance L.P. , as at 10.01.2023

Outlook: Interest rate developments will continue to be the focus of real estate investors in the coming quarter. However, income yields on properties are likely to remain attractive in the coming months. As described above, demand for rental apartments is currently experiencing various positive impulses. These should continue to have a positive influence on the demand for rental flats in the near future. The positive effects on the demand for rental flats are offset by restrained construction activity – the construction tax, higher interest rates and increasing regulation are having a negative impact on construction activity.

The office space market is likely to cool down somewhat again in the coming months because of slowing economic growth.

In general, it is positive to note that rising interest rates also allow for a certain rent increase potential in the most diverse sectors (see Market Outlook 4th Quarter 2022).

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