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Market Outlook Third Quarter 2023

Mixed signals

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Economy
- Strong demand in the service sector meets dwindling orders in industry. Overall, a weakening of the economy is to be expected.
- Inflation is falling but should still be above the central banks' targets in many places at the end of the year.

Financial markets
- Central banks in advanced economies are likely to raise short-term interest rates somewhat further, while long-term interest rates are likely to come under increasing pressure.
- Given the slowdown in economic momentum, we favour less cyclical sectors and companies with healthy balance sheets.

Risks
- Increased geopolitical risks remain on the horizon. A further escalation of the war in Ukraine would cause inflation to rise sharply and at the same time slow down growth, especially in Europe.

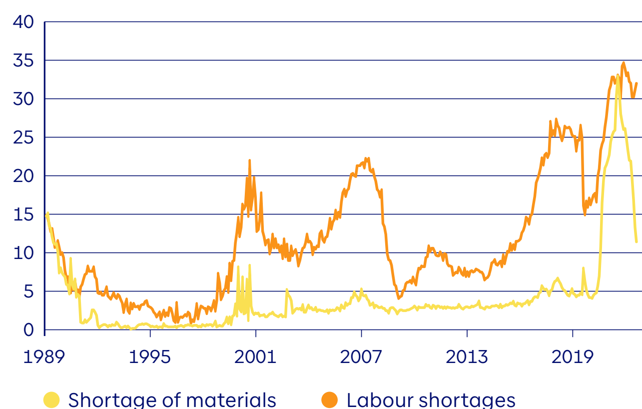
World economy: mixed signals

The global economy has held up better than expected overall, despite high inflation and rising financing costs.

The global purchasing managers' index, a leading economic indicator, rose to an 18-month high in May. This was thanks to the upturn in the services sector. Demand for services is still experiencing pandemic-related catch-up effects. Manufacturing, on the other hand, has been weak for several months, which is a recession signal. This was felt particularly by countries that are more dependent on the manufacturing sector. For example, GDP growth in Germany shrank in the last two quarters.

The latest data for the half-year now shows that the upswing in services is also losing its legs. We therefore expect a more broad-based slowdown in growth momentum in the second half of the year.

EU: Labour shortages remains key constraint
Proportion of respondents (European Commission monthly survey)



Sources: Baloise, Bloomberg Finance L.P. as of 02.07.2023

Inflation

Our lower inflation call from last quarter has been confirmed in recent months. The decline in energy prices and the easing of supply bottlenecks contributed to this development. The price of natural gas in Europe was trading around 75 % lower at the end of the first half of the year than in June 2022 and thus well below the pre-war level. The oil price is also around 40 % lower than in the previous year, despite cuts in production by OPEC+.

This declining trend is likely to continue in the third quarter, but the 2 % target of many central banks is still unlikely to be reached.

Inflation excluding energy and food prices, so-called core inflation, is likely to remain stubbornly high thanks to demand in the service sector and widespread staff shortages.

The unemployment rate in the euro area was 6.5 % in May, the lowest since the founding of the monetary union. Skilled workers thus remain in short supply in many sectors. A survey by the European Commission shows that this remains a major constraint particularly for construction companies (Chart 1).

Past inflation episodes show that the decline in inflation, also called disinflation, starts relatively quickly at the beginning. However, it usually takes one to two years for inflation to fall back to its pre-peak level.

So, the increased inflation rates will be with us for a while.

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Figures at a glance, in percent compared to previous year

		2022	2023
Switzerland	GDP growth	2.2 %	0.8 %
	Inflation*	2.8 %	2.2 %
USA	GDP growth	2.1 %	1.3 %
	Inflation**	4.6 %	3.3 %
Eurozone	GDP growth	3.5 %	0.6 %
	Inflation*	9.2 %	2.9 %
China	GDP growth	3.0 %	5.5 %
	Inflation*	1.8 %	1.2 %

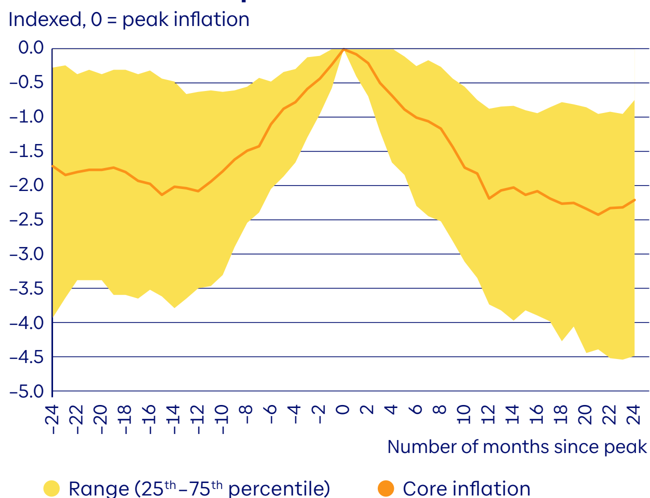
*Year-end value. ** Measured at the consumption deflator.

Sources: Baloise, Bloomberg Finance L.P., as at 04.07.2023

Monetary policy: rate cuts remain fantasies
In the first half of the year, most global central banks raised their interest rates at least once. However, the size of the interest rate steps decreased in recent months. Last year, many central banks raised their key interest rates by 50 to 75 basis points each. In the meantime, interest rate steps of 25 basis points have become the norm again. However, we do not expect any interest rate cuts in North America or Europe this year.

The **US Federal Reserve** (Fed) raised its policy rate three times in the first half of the year by 25 bp to a target range of 5.00 % to 5.25 %. At its June meeting, the Fed paused. Many investors believed that it could soon lower interest rates. The central bank put an end to these fantasies by signalling in June that, given the current environment, it was considering up to two further rate hikes of 25 bp each for the current year.

Historical inflation episodes
Indexed, 0 = peak inflation



Sources: Baloise, BIS, OECD, World Bank, 02.07.2023

The Fed is also sticking to its plan to reduce the balance sheet by up to USD 95 billion per month.

The **European Central Bank (ECB)** is also further reducing its balance sheet. As of July, the redemption amounts of securities acquired within the framework of the “Asset Purchase Programme” (APP) will no longer be reinvested at maturity. The EUR 7.7 trillion balance sheet will thus be reduced by almost EUR 25 billion per month until the end of the year.

At the same time, the interest rate screw continues to be turned. The ECB raised interest rates by 25 basis points in June. The rate on the deposit facility in the euro area climbed to 3.5 %, a 22-year high. The rate on the main refinancing operation is 4 %. In view of high inflation, further rate hikes will be necessary. ECB chief Christine Lagarde made this clear during the last press release.

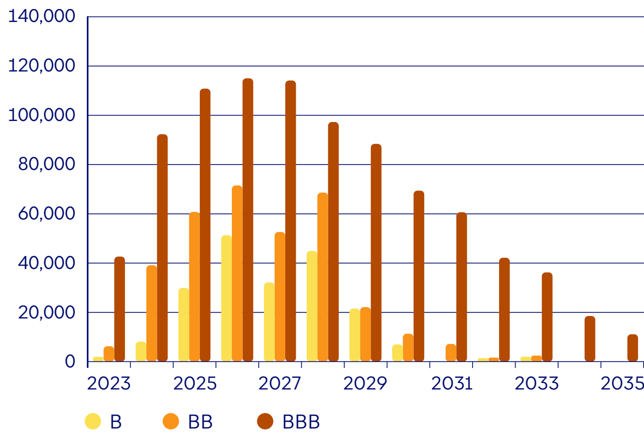
The inflation picture in Switzerland looks much more relaxed. At 2.2 %, inflation was only just above the target range of the **Swiss National Bank** (SNB) when it raised the key interest rate by 25 bps to 1.75 % at the end of June. Compared to June 2022, the SNB key interest rate is now 2.5 percentage points higher. There has never been such a sharp rise in interest rates within twelve months in Switzerland in the last 20 years.

Unlike during the negative interest rate environment, the SNB has also sold foreign currency in recent quarters. This strengthens the Swiss franc and thus dampens inflation from abroad. The SNB is also likely to use this tool to curb inflation in the coming months.

Bonds: Refinancing wall comes in 2024
Review: Credit spreads on USD corporate bonds in the investment grade segment rose in May. Thanks in part to surprisingly strong US economic data, spreads fell from mid-May until the end of the quarter. As of 30 June 2023, average spreads were 14 basis points lower than at the beginning of the quarter. The same dynamic was seen for USD high-yield bonds. The credit risk premium fell by a total of 65 basis points in the second quarter and was thus 79 basis points lower at the end of the first half than at the beginning of the year.

The development of credit spreads for EUR corporate bonds was more restrained. In the investment grade segment, these primarily moved sideways and were 7 basis points lower at the end of the first half than at the end of Q1 and thus only slightly below the level at the beginning of the year. In the case of EUR high-yield bonds, there was a stronger decline of around 41 basis points in the second quarter.

Outstanding amounts of EUR corporate bonds (non-financial companies)
In million EUR



Sources: Baloise, Bloomberg Finance L.P. as at 02.07.2023

Outlook: In our opinion, the high refinancing costs will have a dampening effect on corporate investment spending. Lower real household incomes will also weigh on private consumption. Against this backdrop, we expect economic momentum to slow in H2 2023 and therefore favour companies from less cyclical sectors, with healthy balance sheets and a balanced maturity profile.

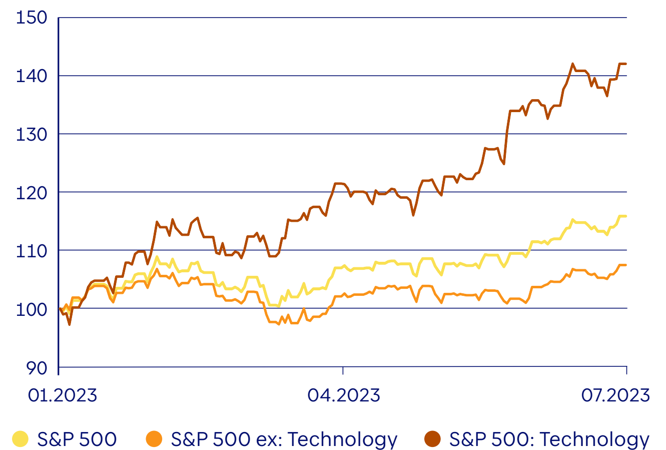
Low interest rates favoured many M&A activities in the past. Companies have been willing to pay high valuations, which has resulted in increased goodwill positions on some balance sheets. A revaluation of these assets could make refinancing even more difficult for some companies. Many companies – especially in the high-yield segment – have already made provisions for 2023; the big "refinancing wall" will then begin in 2024.

Equities: The AI bull market?
Review: When a stock market rises by 20 per cent from its last low, investors speak of a bull market.

For the S&P 500, such a bull market began in early June. However, the upswing in the US stock market is not broad-based. Rather, it was fuelled by a handful of technology stocks that benefited from the euphoria surrounding artificial intelligence (AI). The US tech sector rose by 42 % in the first half of the year, while the rest of the S&P 500 universe only rose by around 7 %.

The Swiss and euro equity markets did less in the second quarter. Over the year, however, both markets are clearly up, by 5 % and 16 % respectively. In emerging markets, the hope was that China's reopening would make big waves. However, that was not the case. On the one hand, China's recovery was largely confined to the domestic market and, on the other, it was much weaker than expected. At the end of the first half of the year, emerging market equities therefore showed a performance of a meagre 3.5 %.

US equities: decoupling of the tech sector
Indexed, 100 = values as of 31.12.2022



Sources: Baloise, Bloomberg Finance L.P., as at 02.07.2023

Outlook: The equity markets are benefiting from the further decline in cost pressures. However, in our view, much of this has already been anticipated with current prices.

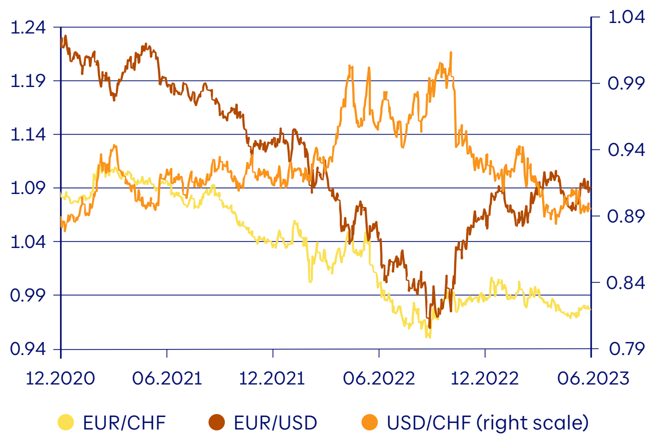
Wall Street's fear barometer, the VIX index, has fallen continuously since the turbulence in the banking sector in March. It is currently at its lowest level since the beginning of the pandemic and also well below the average of the last 20 years. The mood on the stock markets is thus more euphoric than the economic outlook would suggest. We therefore assess the potential for further significant price gains as limited and prefer a rather defensive orientation and a differentiated view.

In terms of regions, US equities are particularly unattractive in the context of higher interest rates. In the short term, these could still benefit from the AI boom, but due to the lack of market breadth, this trend is also particularly vulnerable to price corrections. The Swiss equity market, on the other hand, is more defensively positioned. The SMI also benefits from a dividend yield of over 3 %, which is attractive at least compared to the local bond market.

Currencies: Franc strength continues

Review: In the USA, the political debate surrounding the renewed raising of the debt ceiling fuelled volatility. The greenback lost 2.2% of its value against the strong Swiss franc in the second quarter. The US dollar also came under pressure again against the euro. This was even though the euro also lost some of its strength. After the euro benefited at the beginning of the year from the easing of the energy crisis and positive economic data, the mood turned in the second quarter. It was still able to hold its ground against the US dollar, but compared to the Swiss franc, the euro lost 1.5% from March to June. At the half-year point, the euro was thus at CHF 0.97697.

Development Currencies



Sources: Baloise, Bloomberg Finance L.P., as at 02.07.2023

Outlook: The expected deterioration of economic data in the euro area should put pressure on the euro in the third quarter. Against the US dollar, however, the euro should initially benefit from the shrinking interest rate differential. We expect the ECB to raise interest rates more by the end of the year than the Fed. Thus, the euro could even appreciate slightly against the US dollar.

The situation is more difficult against the Swiss franc, which is supported by the SNB. The SNB publishes data on its foreign exchange transactions with a significant delay. In June, it announced that it had sold CHF 32.3 billion of foreign exchange in the first quarter of 2023. That is five billion more than in the previous quarter. We assume that the SNB will intervene in the foreign exchange market as in recent months to support the strength of the franc.

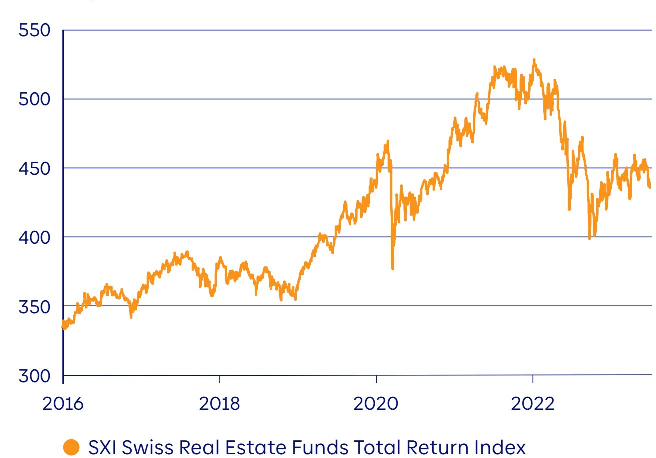
Real Estate Switzerland

Retrospect: On 22 June 2023, the Swiss National Bank made its latest interest rate move. In the week of the SNB's monetary policy assessment between 19 June and 23 June, the SXI Real Estate Funds Broad Total Return Index fell slightly and closed the week around 2.0% lower at 442.73 points.

At the half-year point, the index closed at 436.67 points and thus with an annual performance of –0.8%.

The interest rate increases and thus the higher average interest rates on mortgages have led to the reference interest rate being raised by 25 basis points from 1.25% to 1.5% by the Federal Housing Office in June 2023.

Development real estate funds Switzerland



Sources: Baloise, Bloomberg Finance L.P., as at 02.07.2023

The interest rate trend is also increasingly noticeable in the direct real estate market. According to Fahrländer Partner (survey of eight valuation houses), the minimum discount rates for multi-family houses have again risen slightly.

The demand for rental flats continues to be positive and is increasing. This is mainly due to immigration, which has once again gained momentum. In the first quarter of 2023, net migration amounted to 26,869 persons, which represents a further increase of 23% compared to the previous year and underlines the attractiveness of Switzerland as a place to live and work.

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Demand and also prices for residential property are heterogeneous and vary according to segment. The demand for condominiums remains stable in the low and medium segments, while a decline in demand is recorded in the upper segment, which is probably due to the increase in mortgage interest rates. Prices for condominiums have increased further – by 5.6 % on average compared to the previous year – but only 0.6 % compared to the previous quarter. Accordingly, rental flats, especially in the higher segment, continue to gain in attractiveness.

Demand and supply for office properties remain stable, although regional differences can be observed. A decline in demand is noticeable in peripheral locations. Retail space remains under pressure. While demand is stable in urban areas, there is a decline in demand in rural areas.

On the supply side, building applications remain stable at a low level. Construction prices are declining slightly at a high level, which is due to the fact that the supply chains are functioning more stably again.

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, the demand for rental housing is currently experiencing various positive impulses. These are also likely to have a positive influence on the demand for rental flats in the near future. The positive effects on the demand for rental housing are offset by stagnating construction activity. The higher interest rates as well as the increasing regulation and lengthiness of approval processes are having a negative impact on the supply side.

The office space market is likely to cool down somewhat again in the coming months. This is a consequence of the reduced economic growth.

Retail space in peripheral locations remains under pressure, which on the one hand has a negative impact on prices, but on the other hand also encourages owners to convert the space.

The adoption of the Climate Protection Act by the Swiss electorate on 18.06.2023, offers on the one hand the possibility for property owners to benefit from subsidies for the replacement of fossil heating systems. On the other hand, owners are now also obliged to reduce CO_2 and greenhouse gas emissions. It also shows that climate protection is important to citizens and that the offer should be geared to these needs.

Editorial

Melanie Rama
Senior Economist, Investment Strategy
melanie.rama@baloise.com

Dominik Schmidlin
Head Investment Strategy
dominik.schmidlin@baloise.com

Dominik Sacherer
Portfolio Manager Fixed Income
dominik.sacherer@baloise.com

Baloise Asset Management Ltd
Aeschengraben 21
4002 Basel
baloise.ch

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