Investors' Outlook

When the Fed sneezes …

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Content

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When the Fed sneezes …

—
Dan Scott
Head of Vontobel Multi Asset,
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Dear readers,

The incubation period between central banks' rate hikes and the first symptoms appearing in the real economy has come and gone.

The past month showed rates can't be increased without something breaking. The first wave of problems in crypto markets rippled over into venture capital before spilling over into the first real collapse in regulated markets and the banking sector. Contagion fears spread and a crisis of confidence broke out. The situation was so fragile that it didn't take more than two simple words by Credit Suisse's top shareholder ruling out further investments to help trigger a loss of confidence—and seal its fate.

Given the media headlines that appeared as quickly as they disappeared, googling for financial health check information led some investors to worry if their chills were indicative of a potential 2008 global financial crisis relapse.

What medicine did we employ? Preventative measures were already in place. Cutting risk in our portfolios, going neutral on equities, and staying underweight on high-yield bonds proved to be the perfect move to protect our clients' assets ahead of the turmoil March ushered in.

So, what's the prognosis for the global economy? Central banks are now between a rock and a hard place; having to choose between financial stability and price stability is a bitter pill to swallow. They're likely to favor price stability, though the cocktail of a slowing economy and weakening inflation rates makes a recession more probable—and with that, rate cuts.

Given the heightened volatility in the markets, we believe it is too early to lean out the window and pick up perceived opportunities, as the situation could still take a turn for the worse.

In this Investors' Outlook, you will find our take on the most recent developments in the markets and economy. We take a closer look at the US labor market, where we're starting to see the first cracks appear, and weigh the damage that's been done in the banking sector and whether we're in for a repeat of 2008. You can also read up on the details of our asset allocation and why we have decided to refrain from any changes.

Our focus topic this month delves into US stocks and how our colleagues in the Quality Growth Boutique help clients find opportunities in the country's equities landscape—which is of particular importance in the current market environment.

While we will let the dust settle before making a move again, we are keeping a close eye for signs of convalescence.

Bless you and Gesundheit.

→ Webcast
To view our webcast on recent market developments, click **here.**

—
Frank Häusler
Chief Investment Strategist,
Vontobel

Weathering the cold

Economic reality is closing the gap on our baseline scenario, which we presented at the end of 2022: Rate hikes have started to wreak havoc in the real economy and have claimed their first victims. With a recession now likely and the US labor market showing first signs of cooling, we feel well-positioned to weather the cold with a neutral view on equities while favoring government bonds and gold.

A bank run and spreading panic that led investors to dump financial stocks brought about the failure of Silvergate Capital and Silicon Valley Bank (SVB) in the US. An orchestrated deal by Swiss authorities for UBS to take over embattled competitor Credit Suisse followed in an attempt to stem the crisis, which sent shockwaves around the world and underpinned fragile market confidence.

The damage is done; economic leading indicators will likely go lower from here. The US labor market will take center stage and worsen in the coming months, culminating in a recession, which has historically resulted in rate cuts, which we expect this year.

We reiterate our neutral stance on equities. While central banks have started to strike a more dovish tone, things will likely get worse before they get better. Amid slowing economic growth, weaker inflation, and a peak in central bank hawkishness—which argues for lower rates and wider spreads in the months ahead—we stick to our overall neutral view on fixed income, though we are overweight on government bonds and underweight in high yield credit.

A neutral view on commodities is still warranted. On the one hand, a slowing economy and peak inflation mean commodities may have their best days behind them for now. On the other hand, the prospect of China's economic comeback argues against going underweight. We still prefer gold with an overweight stance as an efficient hedge against recession risks and geopolitical uncertainty, which held especially true last month. See the details on page 5.

	UNDERWEIGHT significantly	UNDERWEIGHT slightly	NEUTRAL	OVERWEIGHT slightly	OVERWEIGHT significantly	
1 Liquidity			→			We stay put on cash for the time being but are ready to redeploy capital as soon as more attractive entry opportunities emerge.
2 Bonds			→			We reiterate our neutral stance on fixed income and remain overweight on government bonds. Our base case scenario is centered around slowing growth, slowing inflation, and a “peak” in central bank hawkishness. This combination argues for lower rates and wider spreads in the months ahead. We therefore continue to feel comfortable with an overweight view on government bonds and a negative view on high-yield bonds. We stay neutral on investment-grade credit and keep a small overweight when it comes to emerging-market debt in hard currency. This results in an overall neutral view on the fixed income segment, unchanged from last month.
3 Equities			→			At the February meeting, the Vontobel Investment Committee decided to lock in gains from our equity overweight that had been in place since late September 2022. We brought equities back to neutral, reallocated the proceeds into cash, and said that we would be ready to redeploy this cash once a better entry opportunity arises. In the absence of short-term catalysts, we think the rally could run out of steam and result in stock market volatility. While central banks have started to strike a more dovish tone, things will likely get worse before they get better. It is therefore not (yet) the time to go overweight again, in our view. As we still have a cautious outlook for the global economy, continue to pencil in a US recession and a later Federal Reserve pivot, we deem it sensible to stay the course and reiterate our neutral view across all regions.
4 Gold				→		We maintain our overweight in gold. We have long argued that gold is an efficient hedge against recession risks and geopolitical uncertainty. This definitively held true last month. On top of that, we are getting closer to a dovish central bank turn—which has historically been positive for gold.
5 Commodities			→			Economic growth is slowing down, while inflation has peaked. This means that the asset class may have its best days behind it for the time being. At the same time, the prospect of a Chinese growth comeback—China is an avid commodity consumer—argues against going underweight.
6 Alternative strategies			→			We stick to our neutral view on alternative investments overall and reiterate all sub-asset class views (i.e., a modest underweight in hedge funds and a neutral view on real estate.)

Changes month-on-month: same → higher ↗ lower ↘

First cracks in the US labor market

In recent months, the US labor market has shown extreme resilience. No matter how often and how sharply the Fed raised interest rates, the labor market simply could not be brought to its knees. The Fed's interest rate hikes are now starting to leave their mark on the labor market. What does this mean for economic growth and inflation?

—
Stefan Eppenberger
Head Multi Asset Strategy,
Vontobel

—
Michaela Huber
Cross-Asset Strategist,
Vontobel

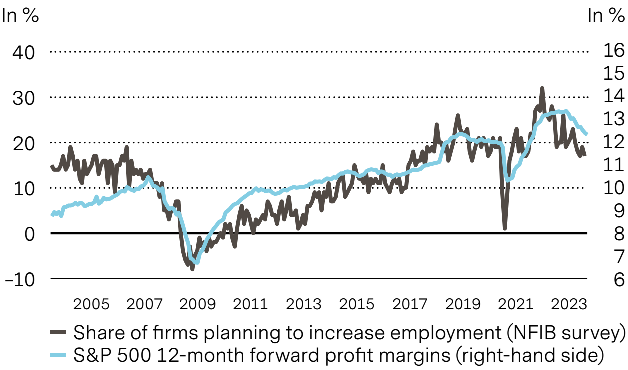
Why do monetary watchdogs and investors keep their fingers on the pulse of the labor market? On the one hand, rising unemployment is a fairly reliable predictor of recessions—and all the consequences that accompany them. On the other hand, a tight labor market comes with persistent wage pressure, which could further fuel already high inflation.

With that in mind, it's worth noting that US companies not only retained their existing employees but also created new jobs month after month. This is underpinned, among other things, by non-farm payrolls, which are still well above pre-pandemic levels. Breaking down non-farm payrolls by individual sectors shows that there have been no significant job losses in the most important industries so far. Not even the sharply declining construction sector recorded any significant job losses.

There are several reasons for the strength of the labor market. First, it faces a classic "supply-demand problem". What does this mean? The Fed's monetary policy aims to reduce demand for goods and services, which in turn should reduce demand for labor. However, the Fed has very limited influence on the supply side of the "equation", that is, on the available labor force. The number of available workers has declined significantly as a result of the Covid-19 outbreak and remains below pre-pandemic levels. This is due in part to older workers who have disproportionately dropped out of the labor force.

Companies have also fared well so far. While profit margins have shrunk, they remain high by historical standards (see chart 1). This allows companies to hold on to their workforce or even add new hires—at least for now.

Chart 1: Profit margins do not (yet) give companies any reason for layoffs



Source: Refinitiv Datastream, Vontobel

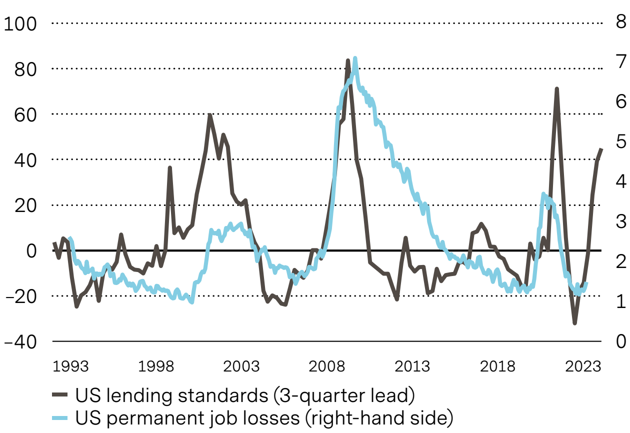
Important: Labor market data are lagging indicators
However, postponed is not abandoned. The labor market usually takes a while before it follows the rest of the developments in the economy. One example of this is the new orders component of the Institute for Supply Management (ISM) survey. Non-farm employment figures usually lag new orders by three quarters. If history is any guide, non-farm payrolls could turn negative as early as May 2023.

Other leading indicators for the US labor market are lending standards, which are also ahead of the number of job losses by three quarters (see chart 2). Now that banks have tightened lending standards significantly in recent months, job losses should soon follow suit.

Cracks are starting to appear
At the end of 2022, we presented our baseline scenario for 2023, highlighting the risk of a recession. Part of this scenario included a significant slowdown in the US labor market. We continue to believe that the negative impact of higher interest rates will hit the labor market with a delay of nine to 12 months—in this case, sometime in the second quarter (Q2). In fact, there are now increasing signs that the US labor market has begun to wobble. According to a report by the employment agency Challenger, 77,770 layoffs were announced in February, a significant increase from the previous year. Other signs of a slowdown include the declining quit rate, which indicates decreasing confidence in the labor market, and the lower average weekly working hours.

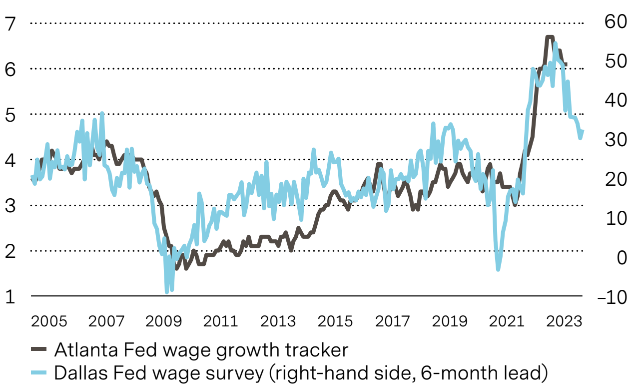
In our view, a cooling labor market will cause wage growth—an important inflation driver—to weaken from its high levels. This is already becoming apparent. Average hourly earnings have started to decline. The Employment Cost Index, a survey of employers' payrolls conducted by the US Bureau of Labor Statistics, has also declined recently. Surveys by regional Fed banks, such as the Federal Reserve Bank of Dallas, paint a similar picture (see chart 3).

Chart 2: Tighter lending standards have led to job losses in the past



Source: Refinitiv Datastream, Vontobel

Chart 3: Less wage growth ahead



Source: Refinitiv Datastream, Vontobel

Time for quality in US equities

Most major equity markets suffered in 2022, and the US was no exception—the three major US indices posted their worst year since 2008. It was a perfect storm of persistently high inflation, slowing economic growth, aggressive rate hikes, high and volatile energy prices, war in Ukraine, and rising tension between the US and China. While 2023 had been off to a somewhat solid start, the recent failures of Signature Bank and SVB in the US, as well as the takeover of Credit Suisse by UBS, have called into question the stability of the financial system and the health of banks around the world. Markets are on edge as investors continue to wrestle with uncertainty. Is a recovery in US stocks feasible? Will the Fed navigate a hard or soft landing? Have earnings bottomed out?

—
Chul Chang
Portfolio Manager,
Senior Research Analyst,
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—
Ben Falcone
Head of Client Portfolio Manager,
Team Quality Growth Boutique,
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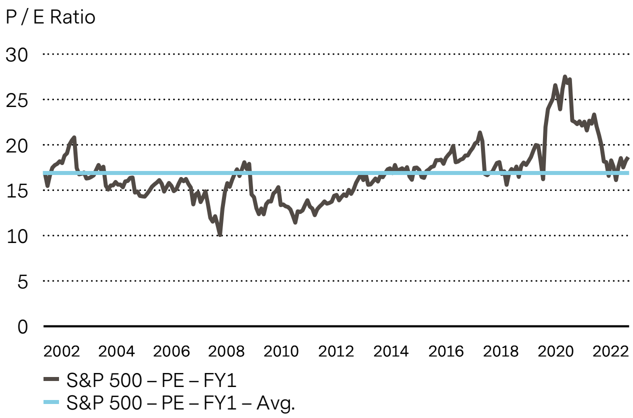
Rather than answering questions that keep investors awake at night, we believe the best line of defense in difficult times is to focus on fundamentals, maintain a long-term perspective, and prepare for the worst. As such, we seek to invest in quality companies—businesses with attractive underlying economics that have sustainable and predictable earnings streams. We continue to find companies in the US that meet our strict criteria for investment, and in our view, a quality approach to US equities will be necessary to successfully navigate the markets this year.

US equities—tried and true
The US stock market remains the most liquid and largest in the world. It is home to many global leading companies, like Amazon and Alphabet, that have a mindset of innovation and can turn their ideas into successful products and services on a global basis. With many US-listed companies, investors can gain access to international markets. In fact, the top 10 US companies by market capitalization in the S&P 500 Index generate an average of about 44 percent of their revenues outside the US. Importantly, US companies are more profitable than their peers, in aggregate, as measured by broad market indices.

US equity valuations have come down significantly. This swift correction has provided a promising backdrop for managers focused on quality to find better entry points. The sell-off in the tech space has rightly punished many speculative, lower-quality companies, but it has also indiscriminately impacted the valuations of some very high-quality tech companies. Such dislocations provide opportunities to add to quality investments at better prices. It is unclear whether markets are nearing an end to valuation compression, but economic weakness will start to filter into earnings pressure on companies this year (see chart 1).

Chart 1: Market multiples have returned to historical average



Source: FactSet

Markets can no longer rely on artificial support
Since the Global Financial Crisis, the US and other large, developed economies have aided financial markets as their central banks kept rates at historically low levels. They also expanded their balance sheets, which supported fixed income markets and provided fiscal stimulus when necessary. This strong cocktail led to a market characterized by low volatility, low dispersion, and hence a high correlation of returns among S&P 500 constituents and the consistent growth of passive dominance for investors seeking US exposure.

The result has been strong market returns over this period. However, going forward, persistent inflation, bloated central bank balance sheets, and government indebtedness look to be less of a tailwind, at best. The abrupt shift to increasing rates to fend off inflation while also decreasing the size of balance sheet assets potentially portends a more difficult environment ahead, as indicated by the current inverted yield curve. We are already starting to see the effects of this abrupt change with SVB's forced recognition of impaired fixed income assets triggering the need for more capital, a run of deposit withdrawals, and eventual collapse with reverberations being felt around the industry and the world. US equity markets began pricing in this scenario with negative returns in 2022. However, going into 2023, there is still a disconnect between market earnings expectations and the typical earnings experience during recessions (see table 1).

Prepared for what lies ahead
In a recession, not all companies are impacted equally. We do not make bets on specific inflation or recession forecasts, but rather look for companies that can perform well in a variety of plausible macroeconomic scenarios. Also, avoiding stocks trading at exorbitant multiples lessens the vulnerability to de-rating as a result of higher discount rates.

We seek to invest in companies that have powerful economic returns—high returns on equity, high returns on invested capital, and high free-cash flow conversion. Equally as important is the predictability of these returns, driven by long-standing secular growth. We shy away from cyclicals, a bias which has also historically reduced our volatility. An important point for current times is that higher financial leverage exacerbates the earnings impact of cost hikes. So, we steer clear of over-indebted companies as a matter of basic prudence.

Table 1: US Equities: Earnings expectations are higher than historical earnings during a recession

PEAK MONTH	TROUGH MONTH	MONTHS OF CONTRACTION	QUARTERS OF DECLINE	EPS CHANGE
August 1957	April 1958	8	4	–17.0%
April 1960	February 1961	10	7	–11.7%
December 1969	November 1970	11	5	–12.9%
November 1973	March 1975	16	4	–14.8%
January 1980	July 1980	6	4	–4.6%
July 1981	November 1982	16	4	–19.1%
July 1990	March 1991	8	10	–36.7%
March 2001	November 2001	8	5	–54.0%
December 2007	June 2009	18	7	–91.9%
February 2020	April 2020	2	4	–32.5%
Average Contraction Duration (months)		**10.3**		
Average EPS Decline (peak to trough)				**–29.5%**
Average EPS Decline—excluding tech bubble (2001) and financial crisis (2007)				**–18.7%**

S&P 500 Consensus EPS Growth 2023 = 9.08%

Past performance is not indicative of future results. Forecasts are not guaranteed and actual results may differ materially.
Source: FactSet, National Bureau of Economic Research (NBER), D. A. Davidson

Peak Month is the last month of economic growth before contraction with Trough Month defining the bottom of the contraction (as per NBER).
EPS Change uses S&P 500 reported EPS, trailing four quarters, updated quarterly.

On a sector basis, we tend to invest in consumer staples businesses with strong market shares, consistent demand, and pricing power. Our information technology exposure tends to consist of subscription-based software businesses as opposed to more cyclical exposure. In health care, our holdings consist of equipment businesses benefiting from demographic drivers with more stable market shares vs. more volatile pharmaceuticals. In financials, we have more exposure to monopolistic financial exchanges and have had no exposure to banks, and we prefer niche auction site businesses instead of traditional cyclicals in the industrials sector. That said, here are three ways we are preparing for what lies ahead:

- ***Mitigate risk.*** We stress test every holding for earnings downside and balance-sheet risks for a recession scenario. We expect our portfolio companies to demonstrate greater earnings resilience, in aggregate, compared to a potential decline in aggregate earnings for the S&P 500 benchmark. Our overweight to consumer staples and lack of exposure to energy can protect against volatility. Household names in the strategy, like Walmart or Becton Dickinson, with demand less correlated to the macro economy, have outperformed in past economic downturns due to strong market share, consistent demand, and pricing power.
- ***Focus on pricing power.*** As consumers deplete their excess savings and the economy weakens further, there will be a greater differentiation among firms in their ability to protect margins. Thus, we seek companies with pricing power. Synopsys, for example, offers electronic design automation solutions that are irreplaceable to chip designers in the global electronics market, providing it with pricing resilience. Strong brands, like Coke and Pepsi, also have pricing power. Both have delivered "sticky" price increases and stable margins in the current inflationary environment. Pricing could also come from businesses with strong "moats", like the local monopoly Vulcan Materials has with its quarries. Given the difficult economics to transport aggregates and the lengthy process and necessary environmental demands associated with obtaining a permit for a new quarry, Vulcan can keep up with cost inflation and generate more profitable gross profit dollars.
- ***Don't mistake a great story for a quality company.*** Some of the most popular stocks in recent years declined significantly last year. A company with an interesting business model but without a clear track record of profitable growth is, in our view, just another story. Sometimes a great story turns out to be a Google, sometimes it's a Yahoo. Along with owning Google that now dominates search, we own Intuit, which dominates the well-known Do-It-Yourself tax franchise "Turbo Tax" and is also becoming a mission critical operating system for small and medium-sized businesses with "QuickBooks", all the while delivering significant cash flow.

The US market has corrected over the last year but navigating into an uncertain future with different characteristics than the past will require an adept skillset. We believe concentrating exposure into high-quality businesses whose value will be determined through consistent earnings compounding rather than external support drivers is an attractive option for prospective investors.

Fed funds' path significantly shifts as a result of banking stress

—
Christopher Koslowski
Senior Fixed Income & FX Strategist,
Vontobel

After Fed Chairman Jerome Powell's testimony to Congress, 2-year yields surged above five percent. When the SVB news broke, they came tumbling back down, leading to their steepest two-day decline since the Black Monday market crash of 1987. The global banking turmoil has shifted expectations for the timing of a federal funds rate cut (see chart 1).

Our overall outlook for fixed income remains neutral. We prefer the higher-quality end of the fixed income market, such as government bonds, although we also see opportunity in emerging-market bonds. We maintain a defensive stance towards overall credit allocation, with a neutral position in investment-grade bonds and an underweight in high-yield.

The bond market sees a recession

In the wake of Powell's testimony, yields on the 2-year note shot up above five percent, causing the yield curve to become severely inverted. The yield on 2-year notes was over one percent higher than that of 10-year notes, leading to the most inverted yield curve since the 1980s. The higher the Fed takes interest rates, the greater the chances of a deeper economic downturn. Eventually, this will result in even sharper interest rate cuts and much lower bond yields. The yield curve is a leading indicator of what is currently happening in the economy, in contrast to economic data, which is lagging and subject to big revisions. While using the yield curve as a market timing tool is unwise, it would be equally ill-advised to disregard the message it is sending. The yield curve between 2-year and 10-year notes has remained deeply inverted at minus 61 basis points, a level that indicates a looming recession.

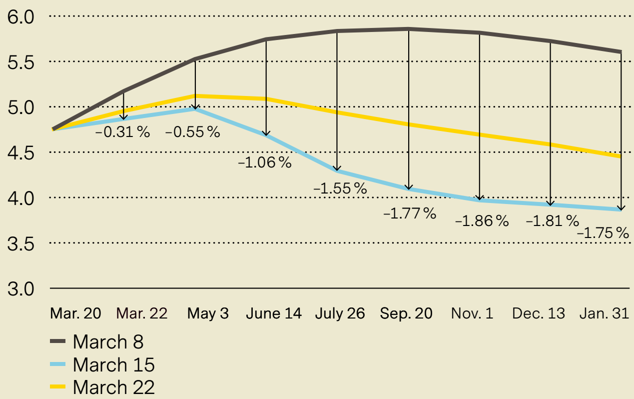
Credit fundamentals, while still strong, are on a negative path

Credit fundamentals are starting to weaken slightly. Profit margins are declining across most sectors, and interest expenses have begun to rise, reflecting the backdrop of higher rates. Even so, leverage is flat for now as debt growth remains prudent. We remain comfortable with the fundamental backdrop overall, although the direction of travel is negative.

From a valuation perspective, both investment-grade and high-yield bonds do not have wide cushions against renewed spread widening (see chart 2).

Chart 1: Expected Fed funds' path amid hawkish Fed speech and risk-off sentiment

Implied Fed pricing, in %



Source: Bloomberg, Vontobel

Chart 2: High-yield breakeven spread indicates a smaller buffer to withstand a wave of spread widening

In Bps

Source: Bloomberg, Vontobel

Financial stability vs. price stability: The Fed's balancing act

—
Mario Montagnani
Senior Investment Strategist,
Vontobel

Equity markets have rebounded strongly since late September 2022. Hopes for an earlier Fed pivot spurred a January rally, which ran into skepticism in February as stickier-than-expected inflation raised the prospects of elevated rates for a longer period than anticipated. Then, something broke in March with the fallout from the collapse of SVB. Are we back to the ailments of 2008?

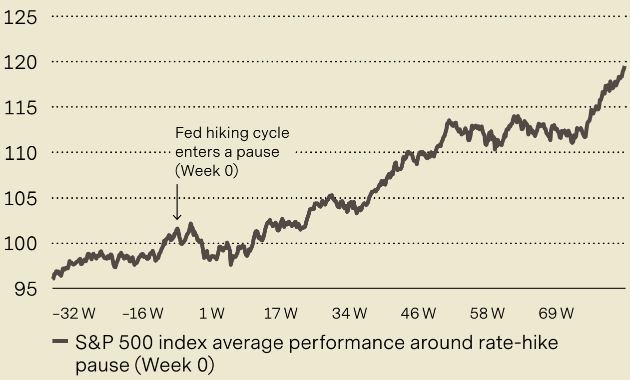
The recent turmoil in the banking sector raised concerns about the balancing act central banks now face, weighing financial and price stability. Along with still sharply inverted yield curves, the situation exacerbated volatility. A recession seems more inevitable than ever, and the turmoil ignited by the SVB fallout could complicate central banks' decisions as it may encourage a slowdown in rate hikes, even as stubbornly high inflation calls for continued hikes. Anyone wondering which camp will win can find the answer in the Fed's last meeting. It signaled the Fed will give priority and unconditional commitment to keeping inflation low.

So, it all comes down to inflation and rate hikes again. The recent events imply that banks will eventually need to recalibrate their lending strategies by de-risking them as the impact of higher rates becomes increasingly visible. Businesses and consumers are likely to be impacted by that. Medium-sized US banks play a crucial role in the economy as they account for 60 – 80 percent of residential and commercial lending—particularly in real estate—and about 50 percent of consumer lending. On a positive note, the current banking crisis could become a deflationary factor, supporting our view that the disinflationary trend observed since July 2022 could continue this year. If history is any guide, central banks usually stop hiking rates when something breaks. And despite the Fed's hike last month, a pause in rate increases could occur as soon as the end of May (see chart 1).

So, are we back to 2008? We don't think so. But even though there doesn't seem to be a systemic risk for banks, we cannot exclude further collateral damage from one of the most aggressive hiking cycles in the past 40 years. A bigger crisis hitting other sectors cannot be excluded. After all, this is by definition the likely outcome of a policy-induced recession. Without powerful catalysts such as easier monetary policy and clear disinflationary trends, equity returns will probably stay muted in the near term (see chart 2). The same applies to a possible Fed pause in the case of an inverted yield curve, as in the current situation, hence our reiterated neutral stance.

Chart 1: S&P 500 index performance around rate-hike pause since 1960

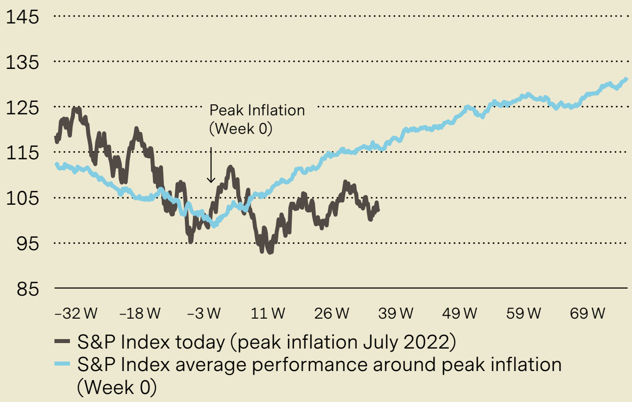
Average S&P 500 indexed performance at Fed pause for rate hikes



Source: Refinitiv Datastream, Vontobel

Chart 2: S&P 500 average peformance around peak inflation periods since 1950

S&P 500 indexed performance at peak inflation



Source: Refinitiv Datastream, Vontobel

Food prices should weaken after a memorable 2022

—
Michaela Huber
Cross-Asset Strategist,
Vontobel

The "perfect storm" and how it materialized

Food prices are known to be inherently volatile. It's not that easy to predict their evolution, as they are influenced by numerous factors. One important driver is energy prices. High oil prices, for example, don't only translate into higher fuel and fertilizer prices but also shift food production to biofuels. A second driver is US monetary policy. Higher interest rates make stockpiling less attractive and dampen speculation. The International Monetary Fund estimates that a one-percentage-point increase in the federal funds rate lowers food commodity prices by 13 percent after one quarter. A third factor is the weather. Droughts or floods can lead to crop failures and reduce supply. In addition, other supply shocks (such as import or export bans), technological advances (such as more efficient harvesting methods), and changing dietary habits (such as increased meat consumption in emerging markets) also play a role.

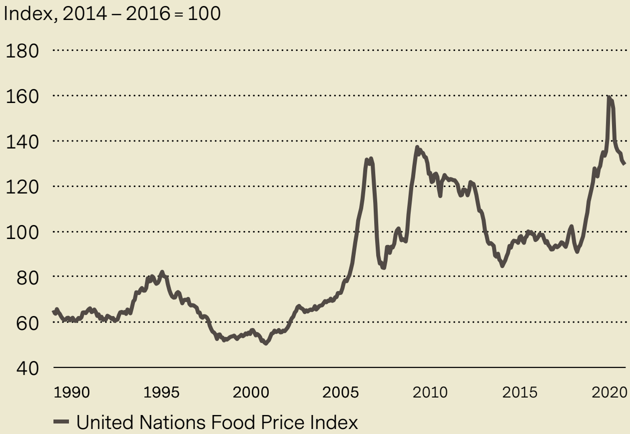
Against this backdrop, somewhat of a "perfect storm" unfolded in 2022. The situation had already been tense in the years leading up to it: various grain-producing countries imposed export restrictions in 2020 for fear of food shortages; consumers and businesses began stockpiling supplies; and the weather phenomenon "La Niña", which spurs extreme droughts and heavy rainfall, put a strain on farmers for a third year in a row. Then, war broke out between Russia and Ukraine—two major wheat producers—and with it, energy costs rose rapidly, driving global food prices to an all-time high (see chart 1).

Why we expect lower food prices in 2023

Food prices have come off their highs but remain elevated by historical standards. We believe there are several reasons why they should continue to weaken:

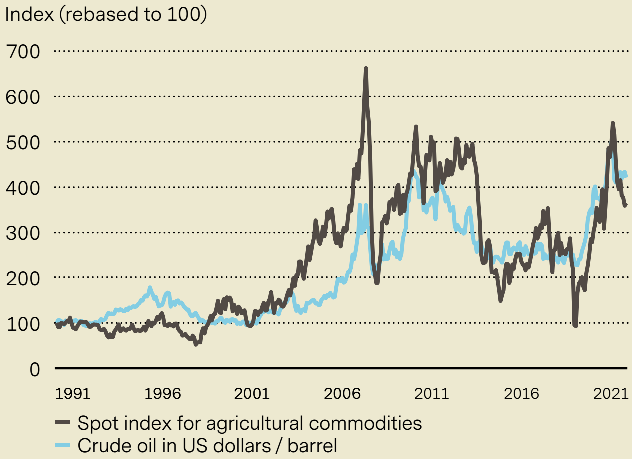
- The Fed's interest rate increases to date.
- The significant decline in energy prices (see chart 2).
- Significantly lower fertilizer prices. Prices for the eight major fertilizers fell in February from the previous month, five of which posted declines of five percent or more, according to DTN / Progressive Farmer.
- Despite inelastic demand, a certain degree of demand destruction can be observed. According to a survey by Aarhus University, some 48 percent of respondents think the war has allowed food retailers and manufacturers to generate higher profits. As a result, consumers are increasingly voting with their feet and refraining from buying certain foods.

Chart 1: Food prices have weakened but remain high



Source: Food and Agriculture Organization of the United Nations, Vontobel

Chart 2: Lower oil prices point to lower food prices



Source: Refinitiv Datastream, Vontobel

Approaching end to Fed's tightening cycle may weigh on US dollar

—
Christopher Koslowski
Senior Fixed Income & FX Strategist, Vontobel

The dominant and most important market theme was concern about systemic vulnerabilities in the banking industry, triggered by SVB's demise, which resulted in yields falling and volatility rising. While this led to downward revisions of rate outlooks for most major central banks, the European Central Bank persisted in hiking policy rates by 50 basis points at its March meeting. Recent events have highlighted the increasing trade-offs central banks must make between the need for restrictive policies to contain inflation and the danger of breaking something of systemic importance.

The medium-term performance of the US dollar will be influenced by monetary policy decisions, and we continue to believe that the approaching conclusion of the Fed's tightening cycle will likely reduce the dollar's attractiveness (see chart 1). Clearer indications of US inflation slowing will increase the currency's headwinds as markets grow more optimistic about the possibility of the Fed changing its course. A weaker backdrop for risk appetite could support the US dollar in the short run, though, via the safe-haven channel.

The euro is set to strengthen
The dramatic re-pricing of the Fed cycle significantly lowered the two-year EUR / USD swap differentials (see chart 2). Exchange rates are typically strongly influenced by rates at the short end of the curve (indicating the path of respective monetary policy), and the sharply narrower spread would be expected to drive the euro much higher. Markets are now betting on the Fed making a U-turn, but they are also factoring in a greater degree of contagion from the turmoil in the banking sector, which is ultimately impacting risk sentiment and preventing the EUR / USD exchange rate from breaking higher for now.

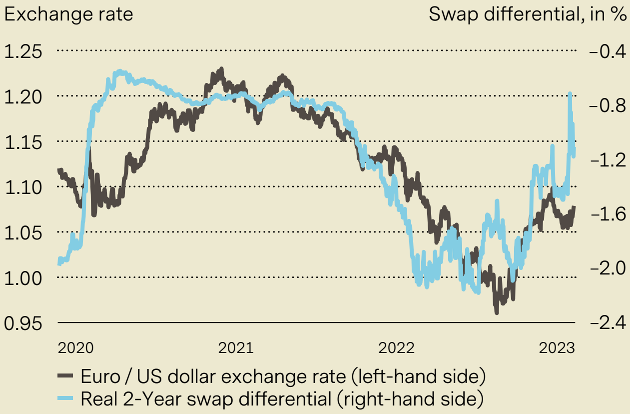
ECB President Christine Lagarde has also provided more details on the key data points the central bank will consider when setting interest rates. These include inflation forecasts, economic and financial data, as well as the dynamics of underlying inflation, with an emphasis on wages. The ECB is also keeping an eye on the strength of monetary policy transmission. We see strong evidence that higher risk-free rates are swiftly passing through to borrowing costs faced by households and businesses. Credit demand and supply is also decreasing quickly.

Monetary policy will likely continue to be just as impactful in the euro zone as it has been in the past; as such, the ECB is poised to raise rates further as we head into the summer months if financial stability is preserved.

Chart 1: The dollar retreats

Source: Bloomberg, Vontobel

Chart 2: Re-pricing of the Fed cycle has caused 2-year EUR / USD swap differentials to narrow



Source: Bloomberg, DB, Vontobel

Economy and financial markets 2021 – 2024

The following list shows the actual values, exchange rates and prices from 2021 to 2022 and consensus forecasts for 2023 and 2024 for gross domestic product (GDP), inflation / inflationary expectations, key central bank interest rates, ten-year government bonds, exchange rates, and commodities.

GDP (IN %)	2021	2022	CURRENT[1]	2023 CONSENSUS	2024 CONSENSUS
Global (G20)	5.6	2.6	2.3	2.2	2.6
Eurozone	5.3	3.5	1.9	0.5	1.2
USA	5.9	2.1	0.9	0.9	1.2
Japan	2.3	1.1	0.4	1.1	1.1
UK	8.5	4.0	0.4	–0.5	0.9
Switzerland	4.3	2.0	0.8	0.6	1.4
Australia	5.3	3.6	2.7	1.7	1.6
China	8.4	3.0	2.9	5.3	5.0

INFLATION	2021	2022	CURRENT[2]	2023 CONSENSUS	2024 CONSENSUS
Global (G20)	3.5	7.3	6.6	5.2	3.5
Eurozone	2.6	8.4	8.5	5.7	2.4
USA	4.7	8.0	6.0	4.1	2.5
Japan	–0.3	2.5	3.3	2.2	1.2
UK	2.6	9.1	10.4	6.5	2.4
Switzerland	0.6	2.9	3.4	2.4	1.4
Australia	2.9	6.6	7.8	5.5	3.1
China	0.9	2.0	1.0	2.3	2.3

KEY INTEREST RATES (IN %)	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR	–0.50	2.00	3.00	3.57	3.51
USD	0.25	4.50	5.00	5.35	4.90
JPY	–0.10	–0.10	–0.10	–0.10	–0.08
GBP	0.25	3.50	4.25	4.35	4.05
CHF	–0.75	1.00	1.50	1.69	1.63
AUD	0.10	3.10	3.60	4.00	3.65
CNY	3.80	3.65	4.35	4.30	4.25

GOVERNMENT BOND YIELDS, 10 YEARS (IN %)	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR (Germany)	–0.2	2.6	2.20	2.66	2.26
USD	1.5	3.9	3.44	3.66	3.38
JPY	0.1	0.4	0.32	0.64	0.68
GBP	1.0	3.7	3.38	3.49	3.11
CHF	–0.1	1.6	1.14	1.59	1.41
AUD	1.7	4.1	3.19	3.81	3.40

FOREIGN EXCHANGE RATES	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS END OF 2024
CHF per EUR	1.04	0.99	0.99	1.01	1.02
CHF per USD	0.91	0.94	0.92	0.92	0.91
CHF per 100 JPY	0.79	0.72	0.70	0.72	0.73
CHF per GBP	1.23	1.12	1.12	1.13	1.14
USD per EUR	1.14	1.06	1.08	1.10	1.12
JPY per USD	115	130	131	127	125.50
USD per AUD	0.73	0.67	0.66	0.71	0.72
GBP per EUR	0.84	0.88	0.88	0.89	0.90
CNY per USD	6.37	6.91	6.88	6.70	6.70

COMMODITIES	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
Brent crude oil, USD per barrel	79	86	75	86.75	95
Gold, USD per troy ounce	1,829	1,824	1,959	1,875	1,875
Copper, USD per metric ton	9,720	8,372	8,922	8,500	9,350

1 Latest available quarter
2 Latest available month, G20 data only quarterly
Source: Vontobel, respective statistical offices and central banks; as of March 25, 2023

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