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Vontobel

Investors' Outlook

Budding hope

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Budding hope

—
Dan Scott
Head of Vontobel Multi Asset,
Vontobel

Dear readers,

A blizzard of economic data swept through markets in March, with investors combing through the flurry. But amid the thawing investment landscape, China's economic narrative revealed small but hopeful glimmers of progress.

While it has become commonplace to label China as "uninvestable", for long-term investors to shun and disregard the potential of what will soon be the world's largest economy—even at current growth rates—is not a feasible strategy in our view.

At China's annual meeting of the National People's Congress early last month, messaging tilted toward a focus on growth following years of putting geopolitical priorities and security in the spotlight. The government kept its 2024 growth target at around 5 percent, unchanged from the previous year, and pledged to transition to advanced manufacturing and efforts to mitigate risks in its property market. It also set its consumer inflation target at 3 percent.

We believe this might be the first sign that Chinese officials recognize the need to pay more attention to the economy again. While investors have been disappointed by the lack of major support measures so far, in our opinion, reaching that 3 percent inflation target won't be possible without fiscal stimulus, structural reform, or monetary impulse. It will be up to the Chinese officials to decide on which steps to take, but it seems clear to us that they will have to do something.

China's challenges have led some market observers to point out parallels to what transpired in Japan in the 1990s, when the fading economic miracle resulted in the so-called Lost Decade. As we highlighted in last month's deep dive into whether China is facing a similar fate, there are indeed some notable similarities in structural problems, such as unfavorable demographics in the form of low birth rates and a shrinking working-age population, low consumer demand, and an ailing property sector. The latter remained under pressure in the first two months of the year, with property investment down 9 percent compared to the year-earlier period.

The stimulative arguments, including special ultra long-term bonds and the willingness by the People's Bank of China to make more cuts to the reserve requirement ratio, are positive signals. China's industrial production also rose at the fastest pace in almost two years, jumping 7 percent year-on-year in January and February, beating economists' expectations of 5 percent. Retail sales came in slightly better than anticipated as well, boosted by Chinese New Year spending. When we further consider an uptick in foreign direct investments in China, which had dropped into negative territory for the first time in 25 years in the third quarter of 2023 but recovered in the final quarter of the year, we're left asking ourselves: has China's fizzled economic recovery finally started to take hold?

It is early days yet, but we see the first sprouts of hope and the potential that China could be on the path to recovery. While it may be a tricky one to tackle, improved capital flow and signals of a willingness to domestically do what it takes to stimulate growth would open the door to the possibility of a nice rebound in China.

This Investors' Outlook provides you with a deep dive into the Eurozone economy, a closer look at commodity prices, and details on our asset allocation.

Traversing the slope toward economic recovery may be slippery, but we always aim to provide our clients with steady footing.

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

—
Frank Häusler
Chief Investment Strategist,
Vontobel

Springing forth

While US Federal Reserve (Fed) and European Central Bank (ECB) policymakers assessed the economic environment and contemplated the timing of interest-rate cuts, the Swiss National Bank (SNB) forged ahead, becoming the first major central bank to ease monetary policy. The move should help rein in the strong Swiss franc. Meanwhile, the Bank of Japan, which was "the last dove standing", delivered its first rate hike in 17 years, ending its negative-interest era while scrapping its controversial yield curve control policy in place since 2016.

Recent inflation data came in stronger than expected, though we don't expect it to be much of a problem this year. Fed Chair Jerome Powell seems to share that view, saying the underlying story hasn't changed. The Fed still expects to cut interest rates three times by the end of 2024. Considering stubborn service price inflation, central banks may start to cut a bit later and less than originally thought—but more than what's currently priced in.

The Fed also updated its growth outlook. It now expects the world's biggest economy to grow 2.1 percent in 2024, well above its December forecast of 1.4 percent. Despite higher growth, markets are more convinced rate cuts are coming. The ECB is also expected to deliver its first cut in the summer months.

In China, we consider the government's 5 percent growth target and the 3 percent inflation goal to be quite ambitious. The former faces challenging base effects, while the latter seems even more difficult considering China is currently flirting with deflation rather than inflation. We expect fiscal stimulus in the months ahead.

The Vontobel Investment Committee decided not to make any changes to our asset allocation, which means we stick to our overweight stance on equities and gold. Find more details about our positioning on page 5.

	UNDERWEIGHT significantly	UNDERWEIGHT slightly	NEUTRAL	OVERWEIGHT slightly	OVERWEIGHT significantly	
1 Liquidity		→				We remain underweight on cash as we believe that for a nine- to 12-month investment horizon, returns from other asset classes should outpace those from cash.
2 Bonds			→			Our stance remains neutral on fixed income, with a defensive bias at a sub-asset class level. We continue to favor government and emerging-market bonds with an overweight position. Government bonds offer an asymmetric payoff—meaning there is a greater probability for profit than loss—while ensuring protection at current levels. In comparison, emerging-market debt appears more attractive to us than the high-yield segment, where we stay underweight. We anticipate that emerging-market debt will benefit from a weaker US dollar in the future, aligning with our base case scenario when the Fed adopts a 'dovish' stance. Our negative view on high-yield bonds arises from the segment's exceptionally low spreads and rising defaults.
3 Equities				→		Stock markets powered ahead last month; we remain overweight. Central banks don't seem far from a change in direction on interest rates, which we expect as early as June. That was confirmed by the Federal Open Market Committee's (FOMC) March meeting, where policymakers held interest rates steady and members stuck to three projected rate cuts in 2024 despite an improving outlook for economic growth and higher inflation forecasts. This scenario should continue to support valuations of risk assets in the midterm. We continue to favor quality and earnings predictability, which we see best reflected in US and Swiss equities, where we remain overweight. Interestingly, the SNB unexpectedly cut its key interest rate in March following encouraging progress on the inflation front. This move comes months ahead of global peers as policymakers try to prevent the franc from appreciating and should play in favor of defensive Swiss stocks. We stay neutral for Japanese and emerging-market equities and retain our underweight on their European counterparts.
4 Gold				→		We maintain a moderately positive outlook on gold. Its historically low correlation with other asset classes makes it an effective hedge in periods of economic uncertainty. Gold can also serve as a hedge against inflation, preserving wealth as fiat currencies (currencies not backed by a precious metal) weaken. Moreover, gold is a safe-haven asset amid geopolitical tensions and uncertainty. As central banks approach a pivot, we expect gold to be further bolstered by loose monetary policies and low real interest rates globally. Demand from central banks, especially those in emerging markets, are likely to further boost gold.
5 Commodities		→				A mixed growth outlook for the global economy has us maintaining a cautious stance on commodities, an inherently cyclical asset class. We remain underweight. However, potential upside risks could arise from an unexpected acceleration in the Chinese economy and escalating geopolitical tensions amid Ukrainian attacks on Russian oil refineries.
6 Alternative strategies			→			We keep our neutral take on alternative funds and real estate. Within alternative funds, we like insurance-linked securities. They tend to have a low correlation with traditional financial markets, as their performance is linked to specific insurance events. That can help reduce overall portfolio risk.

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

Checking the Old Continent's economic temperature

Economists like to use the label "sick man of Europe" when referring to an economically ailing European state. In 2022 and 2023, a whole armada of "men" seemed to be suffering: Germany, Europe's largest economy and heavily export-driven, was weighed down by weak demand from abroad, the aftermath of the 2022 energy crisis after Russia's invasion of Ukraine, challenges in the domestic real estate market, and repeated protests. France and Italy also struggled with subdued industrial demand and workers going on strike.

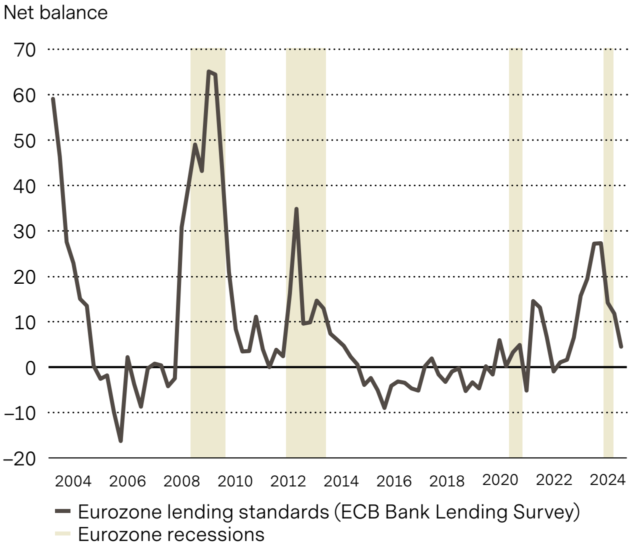
—
Stefan Eppenberger
Head Multi Asset Strategy,
Vontobel

—
Michaela Huber
Cross-Asset Strategist,
Vontobel

After two years of below-average growth, the region's economy has recently appeared to have stabilized somewhat. There are several reasons for this. On the one hand, the worst effects of higher interest rates seem to be behind us. According to the ECB's Bank Lending Survey, European banks have significantly relaxed their lending standards in the last few months (see chart 1). At the same time, banks are expecting higher demand for credit in the second half of the year.

Lower inflation is a further tailwind. European producer prices have been in negative territory for months and fell by a further 8.6 percent year-on-year in January. This was partly due to significantly lower energy prices. Consumer prices are also on the right track, rising "just" 2.6 percent in February. However, certain expenditure items, such as services, remain stubbornly high at just under 4 percent. Services are considered the most complicated component of inflation, as wage growth in labor-intensive production is passed on with a considerable time lag.

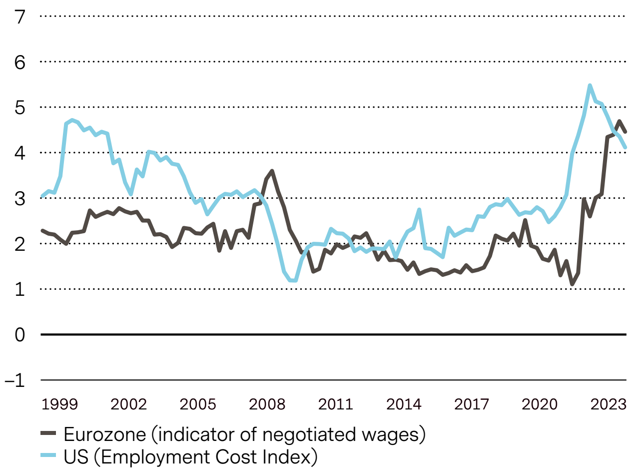
Chart 1: Eurozone banks have significantly eased lending conditions



Source: LSEG, Vontobel; data as of March 15, 2024.

Chart 2: Eurozone wage growth has peaked, but stays too high

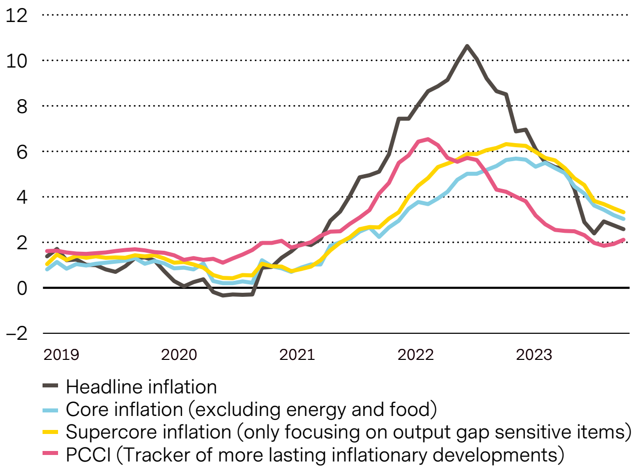
Year-on-year percentage change



Source: LSEG, Vontobel; data as of March 15, 2024.

Chart 3: Core inflation measures are easing steadily

Year-on-year percentage change



Source: LSEG, Vontobel; data as of March 15, 2024.

Stabilization in the absence of significant economic acceleration

While lower interest rates and decreased inflation should provide a boost to the economy, there is little support from the fiscal side. According to the International Monetary Fund (IMF), European heads of state, unlike their American counterparts, are exercising fiscal restraint, which can, for example, be observed in the fact that the fiscal impulse has been shrinking for two years.[1] In its forecasts, the IMF doesn't foresee this impulse turning positive in the coming years. Consumers are unlikely to provide a significant uplift in the near future. While private consumption in the US has repeatedly surprised on the upside and proven to be extraordinarily resilient, the story looks very different across the pond, where private consumption collapsed with the energy crisis and has not recovered since.

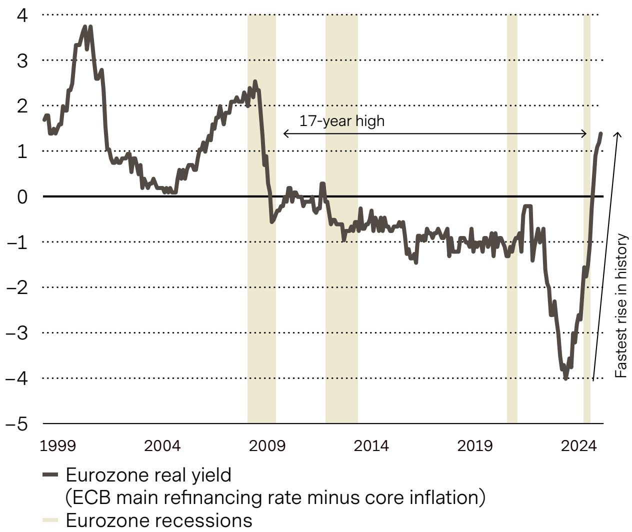
Current monetary policy is too restrictive

Be that as it may, the ECB is in no hurry to cut interest rates, with ECB President Christine Lagarde repeatedly referring to continued robust wage growth (see chart 2). As a result, along with many of her colleagues, she wants to wait for wage data to be published in the second quarter. Lagarde's comment that we will know "a little bit" in April and "a lot more" in June could point to an initial interest-rate cut in June.

In our view, this fixation on wages is misplaced. Firstly, wages are one of the most lagging indicators. The recent strong rise in wages can be viewed as a kind of catch-up process for real incomes (i.e., incomes adjusted for inflation). That's because wages typically only react to past inflation. The ECB should not get too hung up on them, in our opinion. Secondly, certain core inflation measures developed by the ECB itself have already returned to the 2 percent inflation target (see chart 3).[2] Thirdly, a look at real interest rates (ECB refinancing rate minus core inflation) also shows that it is time for interest rate cuts: although the ECB has not raised interest rates for months, real interest rates have continued to rise steadily due to lower inflation (see chart 4), thus dampening the much-anticipated economic recovery.

Chart 4: Real yields continue to rise (now due to lower inflation)

In %



Source: LSEG, Vontobel; data as of March 15, 2024.

[1] The fiscal impulse is a key figure, expressed as a percentage of gross domestic product, which measures the change in the fiscal budget and its impact on the economy.

[2] One example is the "Persistent and Common Component of Inflation" indicator (PCCI), which measures underlying, persistent inflation, according to the ECB.

First stirrings of easing

—
Christopher Koslowski
Senior Fixed Income & FX Strategist,
Vontobel

The unexpected rate cut by the SNB has solidified expectations for a worldwide easing of monetary policy, beginning this summer. Consequently, traders are now putting greater odds on a rate cut from the ECB in June, followed by the Fed and then the Bank of England (BoE). This prospect provides the bond market with a boost in the wake of the most recent Fed meeting.

During its March meeting, the Fed kept the federal funds rate target range unchanged and continued to signal that three rate cuts of 25 basis points each are the most probable course of action for 2024, despite recently stronger inflation. The summary of economic projections released after the FOMC meeting aligned with expectations, underscoring the confidence of policymakers in tackling inflation and securing a soft landing.

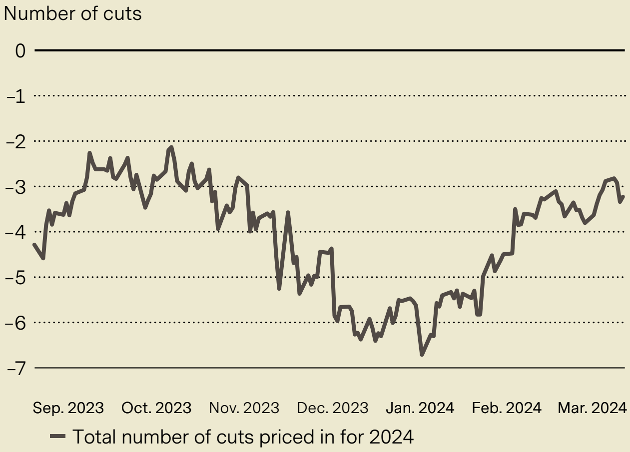
Surprising, and potentially more dovish, was Chair Jerome Powell's frequent mention of the possibility that a rapid weakening of the labor market could lead to a faster decrease in policy rates. He clarified that while this scenario is not the FOMC's base case, it outlines a possible risk. This is particularly relevant considering the hiring rate is already below pre-pandemic levels, suggesting that an increase in layoffs could abruptly shift hiring to negative territory and cause unemployment rates to rise.

The FOMC is poised to start reducing rates in June if there continues to be headway in the inflation picture.

While incoming data remains strong, it is not strong enough to propel yields meaningfully higher from here, especially at a time when the Fed is biased to ease.
The market is now fully aligned with the Fed in expecting three cuts this year (see chart 1). The longer the Fed keeps policy on hold, the greater the impact on the economy; hence, we retain our bias towards lower yields. Against this backdrop, we maintain a preference for government bonds with an overweight position. At present levels, government bonds provide protection and offer an asymmetric payoff.

Navigating tight spreads: a case for caution in credit markets
While Treasury yields remain elevated, credit spreads don't compensate for even a small pickup in defaults. Spreads have tightened significantly, coinciding with increased expectations for lower policy rates and a soft landing of the economy. They've only been tighter than current levels on a mere 6 percent of trading days in the last 25 years (see chart 2). We think this makes it hard to justify taking on extra risk, which is why we prefer being underweight high yield.

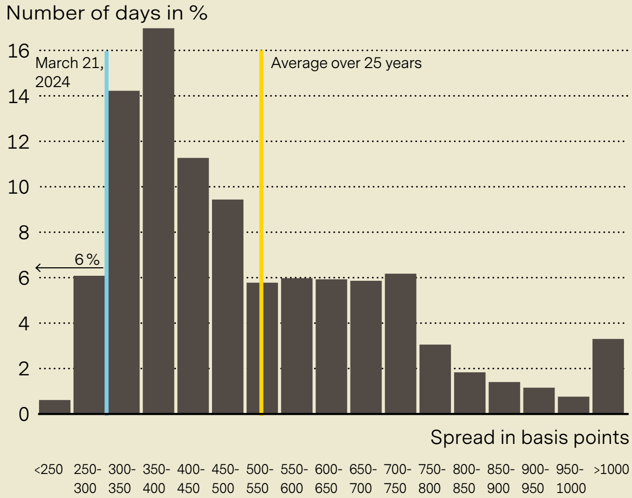
Chart 1: Markets correct towards Fed's forecast as investors see three cuts in 2024



Note: Negative numbers reflect the expected number of interest-rate cuts of 25 basis points each.

Source: Bloomberg, Vontobel; data as of March 21, 2024.

Chart 2: Number of days traded in the respective range for high-yield bonds in the last 25 years



Source: Bloomberg, Vontobel; data as of March 21, 2024.

Equity markets in full bloom

—
Mario Montagnani
Senior Investment Strategist,
Vontobel

Despite lingering concerns surrounding inflationary pressures, geopolitical tensions, and the uncertain trajectory of interest rates, stock markets have continued to move higher. Strong corporate earnings reports, especially in the US, and the perceived approach of central banks' policy shifts fueled investor optimism.

Various indexes have flourished and reached milestones: the MSCI All Country World Index surpassed its all-time high of December 2021; the S&P 500 Index made history by crossing the 5,200-mark for the first time ever. And at the end of February, the Nikkei 225 Index finally surpassed its historic 1989 record (see chart 1).

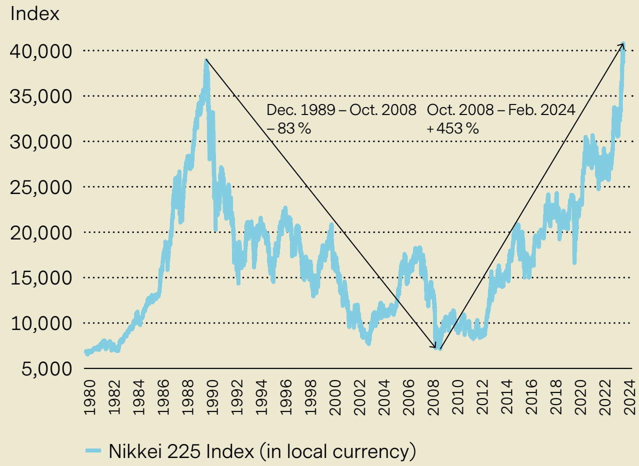
The rally broadened further last month. Since mid-February, equity allocations by global institutional asset managers have increased, according to Bank of America's Global Fund Manager Survey. There was also a powerful style and sector rotation, with a greater focus on value and sectors such as financials, healthcare, consumer staples, energy, and real estate. Regionally, this resulted in higher allocations to European and emerging-markets equities, which outperformed US stocks. This was the case for Chinese and Swiss equities too.

What does this mean?
Retail investor sentiment became bullish in November, to the point of turning from cheerful to greedy, according to the American Association of Individual Investors' Investor Sentiment Survey. This also means that most markets are facing an overbought situation, along with very high valuation multiples for some markets and sectors.

This may have some wondering whether the rally is based on irrationality. We don't think so. Investors need to consider the drastic fundamental and structural change in equity markets that has occurred over the past decade. Taking the US technology sector as an example, the emergence of new structural megatrends resulted in stronger revenue growth, higher margin contribution, and free cash flow generation, which led to excess cash positions often returned to shareholders in terms of buybacks. This environment makes it hardly comparable with the dot-com bubble in 2000 (see chart 2).

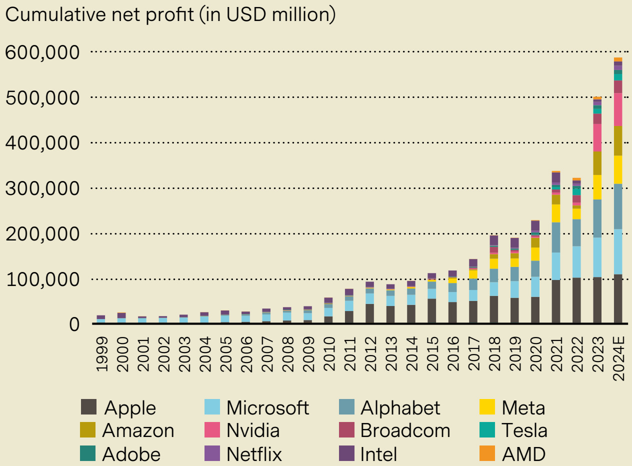
We believe that inflation will continue to grind lower from here, leading central banks to cut rates this year. If history is any guide, markets usually react positively to these moves. We remain overweight on stocks. Find the details of our asset allocation on page 5.

Chart 1: The Nikkei 225 at a record after more than three decades



Source: LSEG, Vontobel; data as of March 21, 2024.

Chart 2: Cumulative profit for the top 12 largest tech / mega-caps in the US



Source: LSEG, Vontobel; data as of March 21, 2024.

The winds of geopolitics support oil

—
Michaela Huber
Cross-Asset Strategist,
Vontobel

Oil prices got a geopolitical boost in March (see chart 1). The wind seems to be shifting increasingly in Russia's favor, as Western support for Ukraine is waning. However, the latter has stepped up its attacks on Russian oil infrastructure and attacked numerous oil refineries.

The resulting reduction in Russian refinery capacity is exacerbating the situation for oil products. If Russia can't process its crude oil, its stockpiles will rise. Russia has already announced that it will increase its oil exports. This is positive for oil products; but the higher supply is not necessarily great news for oil itself. In the absence of an escalation of the conflict, oil is likely to be supported at more than USD 80 per barrel.

"Dr. Copper" recovers (a little)

The recent rise in copper prices was primarily driven by a supply threat. After it was announced that loss-making Chinese copper smelters had jointly agreed to cut output, the red metal briefly approached the USD 9,000 threshold. However, no concrete details were provided, and the rally lost momentum again. There are still headwinds on the demand side. Investments in the Chinese real estate sector, which is important for copper, fell 9 percent in the January-February period. A look at the significant rise in Chinese inventories also raises questions (see chart 2). Without significant stimulus or supply shocks, the upside potential is likely to be limited.

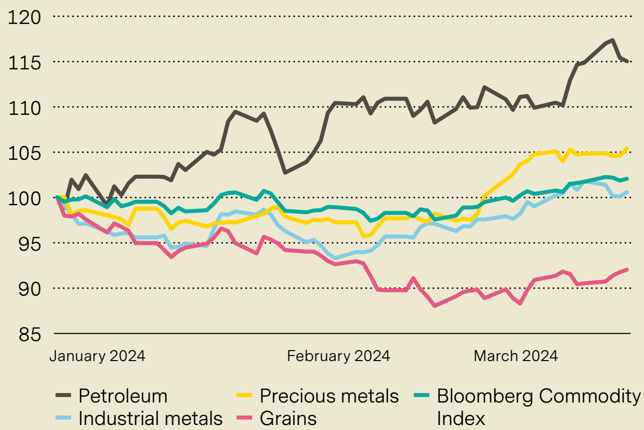
Gold shines

Gold reached an all-time high of more than USD 2,200 per ounce in March. While exchange-traded gold funds have long struggled with outflows—investors withdrew around USD 2.9 billion in February alone, according to the World Gold Council—the unabated strong demand from central banks has more than compensated for this. China's central bank stands out in particular: it bought gold for the 16th month in a row in February and is now sitting on around 72 million ounces (+390,000 in February).

But China's consumers have also made bold purchases despite high prices. One possible explanation could be the country's economic context. While future central bank demand is difficult to predict (and data on this is published with a lag), gold is likely to benefit from the prospect of a weaker US dollar and lower US real interest rates. There should also be some support on the geopolitical front in the coming months, mainly from the war in Ukraine, the tensions in the Middle East, and the upcoming US presidential election.

Chart 1: Commodities' year-to-date performance

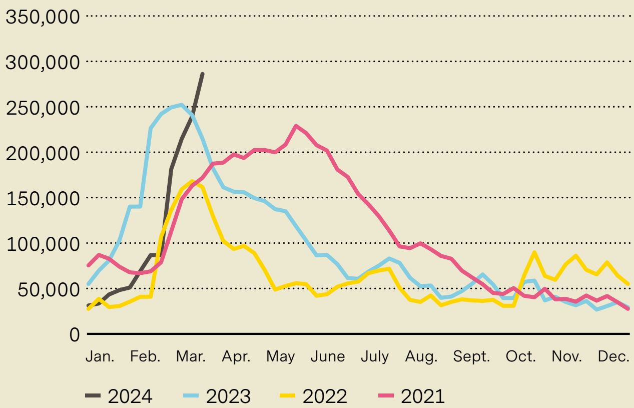
Rebased to 100 = start of 2024



Source: LSEG, Bloomberg, Vontobel; data as of March 21, 2024.

Chart 2: Chinese copper inventories suggest muted demand

Shanghai copper inventories in tons



Source: LSEG, Vontobel; data as of March 21, 2024.

The SNB rings in the rate-cut season

—
Christopher Koslowski
Senior Fixed Income & FX Strategist,
Vontobel

The Swiss central bank took the first step by reducing its key interest rate by 0.25 percent on March 21, setting the new policy rate at 1.5 percent from a previous 1.75 percent. This decision placed the SNB ahead of its global counterparts, which are expected to follow with similar rate cuts in the near future.

The move came as a surprise to many analysts, who had predicted that the central bank would keep its policy rate steady at 1.75 percent. SNB President Thomas Jordan noted that effective measures to tame inflation over the last two and a half years facilitated the step. Furthermore, the SNB lowered its inflation forecast to 1.4 percent for 2024, down from its December prediction of 1.9 percent.

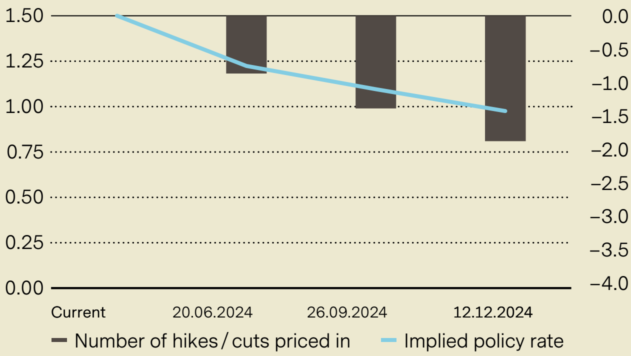
Historically, the SNB has not shied away from stunning the market with sudden moves, and this rate cut could be seen as a continuation of that trend. Noteworthy moments in its past include dropping the Swiss franc's cap against the euro in 2015 and the unexpected 50 basis-point rise in borrowing costs in 2022. The SNB's policy path for the remainder of the year suggests a bias towards further easing, with currently close to two further cuts priced in (see chart 1), bringing the policy rate to 1 percent by the end of the year.

The Swiss franc lost ground in the aftermath of the decision and will most likely continue to weaken against both the US dollar and the euro in the months to come as weaker inflation in Switzerland allows the SNB to accommodate the economy further.

Eyeing the US presidential election
The euro-dollar exchange rate is currently largely influenced by expected action from central banks. However, the upcoming presidential election in the US will increasingly play a significant role in market considerations, particularly with Donald Trump leading President Joe Biden in recent polls (see chart 2). Should Trump secure a victory in 2024, the economic stimulus from tax cuts and business-friendly policies seen in 2016 might not be replicated, given the current low tax rates and substantial budget deficits.

The combination of fiscal and monetary policy could result in more restrictive fiscal measures alongside looser monetary policy, potentially benefiting the euro-dollar exchange rate. On the other hand, a second term for Trump could potentially lead to a stronger US dollar due to safe-haven investments, aggressive foreign policies, and concerns about renewed trade tensions.

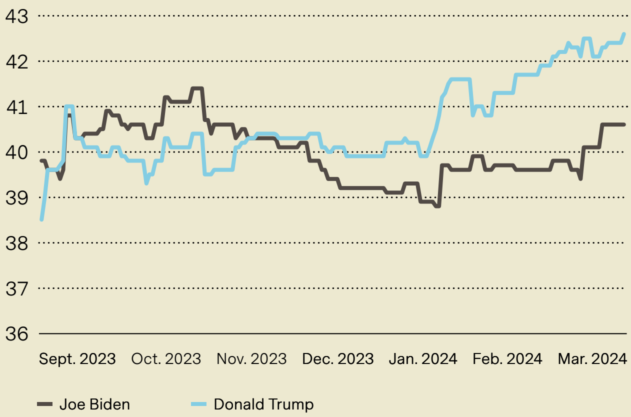
Chart 1: Implied overnight rate and number of hikes and cuts



Note: Negative numbers represent priced in cuts, while positive numbers would represent priced in hikes (no hikes are currently priced in)

Source: Bloomberg, Vontobel; data as of March 21, 2024.

Chart 2: Opinion polls favor Trump over Biden (for now)



Source: Bloomberg, Vontobel; data as of March 21, 2024.

Economy and financial markets 2022 – 2025

The following list shows the actual values, exchange rates and prices from 2022 to 2023 and consensus forecasts for 2024 and 2025 for gross domestic product (GDP), inflation / inflationary expectations, key central bank interest rates, ten-year government bonds, exchange rates, and commodities.

GDP (IN %)	2022	2023	CURRENT[1]	2024 CONSENSUS	2025 CONSENSUS
Global (G20)	2.9	3.1	3.1	2.5	2.6
Eurozone	3.4	0.4	0.1	0.5	1.4
USA	1.9	2.5	3.1	2.1	1.7
Japan	1.0	1.9	1.2	0.7	1.1
UK	4.5	0.3	–0.2	0.3	1.2
Switzerland	2.7	0.7	0.6	1.2	1.5
Australia	3.8	1.9	2.1	1.4	2.3
China	3.0	5.2	5.2	4.6	4.3

INFLATION	2022	2023	CURRENT[1]	2024 CONSENSUS	2025 CONSENSUS
Global (G20)	7.5	4.5	3.6	5.3	3.3
Eurozone	8.4	5.5	2.6	2.4	2.1
USA	8.0	4.1	3.2	2.8	2.4
Japan	2.5	3.3	2.2	2.3	1.8
UK	9.1	7.3	3.4	2.5	2.1
Switzerland	2.8	2.2	1.2	1.5	1.2
Australia	6.6	5.7	4.1	3.3	2.8
China	2.0	0.2	0.7	0.8	1.6

KEY INTEREST RATES (IN %)	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR	2.50	4.50	4.50	3.60	2.80
USD	4.50	5.50	5.50	5.25	4.20
JPY	–0.10	–0.10	–0.10	0.01	0.10
GBP	3.50	5.25	5.25	5.10	3.85
CHF	1.00	1.75	1.50	1.52	1.06
AUD	3.10	4.35	4.35	4.35	3.70
CNY	3.65	3.45	4.35	4.25	–

GOVERNMENT BOND YIELDS, 10 YEARS (IN %)	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR (Germany)	2.6	2.0	2.43	2.18	2.09
USD	3.9	3.9	4.28	3.97	3.73
JPY	0.4	0.6	0.74	0.86	0.95
GBP	3.7	3.5	3.99	3.82	3.56
CHF	1.6	0.7	0.72	0.83	0.83
AUD	4.1	4.0	4.09	4.06	3.78

FOREIGN EXCHANGE RATES	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
CHF per EUR	0.99	0.93	0.98	0.97	1.00
CHF per USD	0.94	0.84	0.90	0.89	0.89
CHF per 100 JPY	0.72	0.60	0.59	0.61	0.64
CHF per GBP	1.12	1.07	1.14	1.12	1.14
USD per EUR	1.06	1.10	1.09	1.09	1.11
JPY per USD	130.00	141.00	151.00	145.00	139.00
USD per AUD	0.67	0.68	0.66	0.67	0.69
GBP per EUR	0.88	0.87	0.86	0.86	0.86
CNY per USD	6.91	7.10	7.20	7.15	7.10

COMMODITIES	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
Brent crude oil, USD per barrel	86	77	86	83	83
Gold, USD per troy ounce	1,824	2,063	2,188	2,050	2,100
Copper, USD per metric ton	8,372	8,559	8,928	8,500	9,182

[1] Latest available quarter
[2] Latest available month, G20 data only quarterly
Source: Vontobel, respective statistical offices and central banks; as of March 21, 2024

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