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Vontobel

Investors' Outlook

Falling into place

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Falling into place

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

As summer fades and this publication returns from its break, our team has been raking through the changing leaves that have shifted market dynamics.

Early last month, investors faced a series of market-moving events: weak US employment data, a surprise interest-rate hike by the Bank of Japan, underwhelming earnings from some of the technology sector's heavyweights that had long buoyed the stock market, and rising tensions in the Middle East. These developments reignited fears of a recession, triggering a sell-off. It served as a sobering reminder that perhaps some investors had been too optimistic, believing the US economy could glide through without facing a downturn.

Viewing the meltdown as a healthy consolidation at a high level, we took the opportunity to strategically add equities to our portfolios, buying the dip[1] as we see attractive upside to US and European stocks. And markets have since rebounded.

Given that August is typically characterized by light trading volumes, limited news flow, and many investors on holiday, it's quite possible that the wild swings were amplified by these illiquid conditions.

We've maintained a steady focus and kept our heads down with a moderate risk-on stance[2], and we're particularly pleased with our overweight[3] stances on gold and government bonds. Despite the deteriorating economic outlook, we believe we have not yet reached an inflection point. Still, we remain vigilant, aware of the sudden squalls that could create potential pitfalls in geopolitics, macroeconomic shifts, or concerns about government deficits.

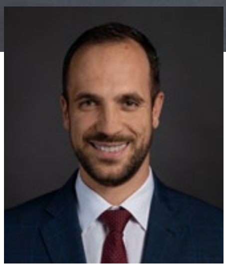
On a brighter note, the US inflation rate eased for a fourth consecutive month in July, bolstering expectations for the US Federal Reserve (Fed) to come through with a long-awaited rate cut this month. And Chair Jerome Powell's key speech[4] at the Fed's annual meeting in Jackson Hole, Wyoming, signaled that the rate cut is indeed around the corner, with Powell saying, "the time has come for policy to adjust" as inflation is on a trajectory towards its 2 percent goal and amid an "unmistakable" slowdown in the labor market. He didn't provide details as to how big the cut would be or what their roadmap looks like through the end of the year, but Powell made it clear the Fed doesn't "seek or welcome further cooling of the labor market". That might indicate that policymakers are open to reducing rates at a faster pace.

In this Investors' Outlook, we bite into the core of the US labor market, peel back the layers of India's economy to see if it could one day match China's strength, and trace the patterns of currency markets.

As the leaves turn and the winds shift, we remain rooted amid jittery markets fueled by recession fears and anticipated policy changes. We aim to help you harvest the opportunities this season brings.

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

[1] See "Glossary and sources" on p. 21.



—
Stefan Eppenberger
Chief Investment Strategist,
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The economic shadows are lengthening

The global macroeconomic picture has grown increasingly worrying in recent months. The Eurozone's economic outlook remains sluggish[5], while data out of China has deteriorated[6], with little indication that the People's Bank of China (PBoC) is ready to introduce significant stimulus measures—though we expect policymakers will eventually need to act to meet the official 5 percent growth target set for this year. However, the primary focus has been on the world's largest economy.

There was plenty to sort through. The closely monitored US labor market didn't turn out to be as strong as previously believed[7], stoking fears that the Fed may have missed the window to cut interest rates in time and could now struggle to stave off a recession[8]. We previously noted that, although the US job market remained robust by historical standards, it had begun to show signs of softening.

With higher interest rates increasingly weighing on businesses and consumers, signs of weakness are surfacing across the economy. Leading indicators in the services sector have weakened[9] considerably, and there is a noticeable rise in credit card and auto loan delinquencies[10].

Of course, there are positive developments as well. With fewer employees leaving their current positions[11], wage pressure has eased. Additionally, inflation has also been trending downwards: consumer price growth slowed to 2.9 percent year-on-year in July, the lowest level in more than three years[12]. Taking all these factors into account, we anticipate that the Fed will be compelled to cut rates three to four times before the end of the year.

We have refrained from making further changes to our portfolio, having already adjusted our allocation in early August. Further details on our asset allocation can be found on page 5, along with an in-depth analysis of the US labor market on page 6.

	UNDERWEIGHT significantly	UNDERWEIGHT slightly	NEUTRAL	OVERWEIGHT slightly	OVERWEIGHT significantly	
1 Liquidity		→				We maintain an underweight position on cash, anticipating that returns from other asset classes will outpace those from cash over the next nine to 12 months.
2 Bonds		→				We reaffirm our underweight position in fixed income. The deteriorating economic growth outlook and the slow pace of inflation normalization have heightened expectations for a Fed rate cut cycle. As a result, bond yields have fallen significantly, with a series of US interest-rate cuts priced in over the next 12 months. Unless there's a recession or another leg down in inflation, yields have little room to move south, making other asset classes more attractive in a multi-asset context. Within fixed income, we remain overweight in government bonds and in emerging market bonds in hard currency. Government bonds provide a solid hedge should our recession scenario materialize, while emerging-market bonds are likely to benefit from a weaker US dollar—our base case if the Fed adopts a more dovish stance. We hold a negative view on investment-grade bonds, due to their low yield pick-up relative to government bonds, and on high-yield bonds, due to the increasingly challenging economic environment.
3 Equities				→		We took advantage of the recent stock market sell-off to bring our allocation back to target, meaning we bought the dip. We stick to our slight overweight. In the near term, we remain mindful of a possible volatile environment as we enter the month of September as well as considering the softening economic outlook. A Fed rate cut would support equities. We still believe US and Eurozone stocks—both overweight—will outperform their Japanese, Swiss and emerging-market peers within the next 12 months.
4 Gold				→		We favor gold with an overweight position. After an impressive rise over the summer, gold reached a record high at the end of August. Economic and geopolitical uncertainties played a role, but the main impetus came from the hope for US interest-rate cuts. Interestingly, the factors that have driven gold demand in the recent past, such as central bank and emerging market demand, seem to be becoming less important. It's now being driven by more traditional factors, such as US real yields and the US dollar. Our expectation of lower US real yields and a weaker US dollar argues for maintaining a slight overweight. Gold also serves as a hedge against recession and geopolitical risks (e.g., Middle East, Russia-Ukraine, US elections).
5 Commodities			→			We uphold our neutral stance on commodities after a difficult summer. Oil was caught between a rock and a hard place (geopolitics vs. slowing demand), industrial metals suffered from the interplay of too much supply and too little demand (Chinese overcapacity vs. subdued industrial/property demand), and agricultural commodities had to contend with oversupply (high crop yields in key producing regions). While our cautious economic outlook argues against this cyclical asset class, our expectations of US rate cuts and the ensuing economic reacceleration, plus a weaker US dollar, could provide some support. We also remain mindful of the potential for further Chinese stimulus towards the end of the year, as well as geopolitical developments.
6 Alternative strategies			→			We stay neutral for alternative funds (with a preference for insurance-linked securities) and real estate.

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

Winter is coming

The US labor market and summer this year share a common trait: both were "hot" for a long time. While other areas of the economy weakened under the pressure of restrictive monetary policy, the labor market remained resilient and tight. But even the best summers eventually come to an end.

—
Michaela Huber
Senior Cross-Asset Strategist,
Vontobel

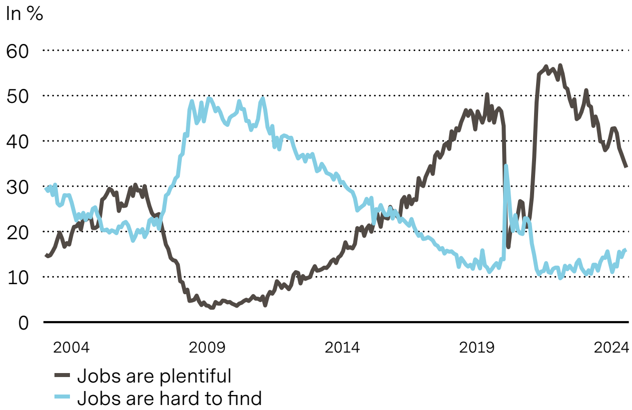
—
Stefan Eppenberger
Chief Investment Strategist,
Vontobel

Various surveys were already forecasting cooler conditions ahead. According to the Conference Board, US consumers are increasingly pessimistic about the labor market[13] (see chart 1), while demand for temporary staff has been declining for some time[14], a trend often seen as a precursor to layoffs of permanent employees.

However, the real chill set in with the release of the July monthly labor market report. According to the Bureau of Labor Statistics, some 114,000 new jobs were created, significantly below the expected 175,000[15]. Data for June and May were also revised downward. At the same time, the unemployment rate rose from 4.1 percent to 4.3 percent, according to the report. The core unemployment rate[16], which tracks individuals not just temporarily unemployed, also edged up slightly from 1.40 percent to 1.44 percent.

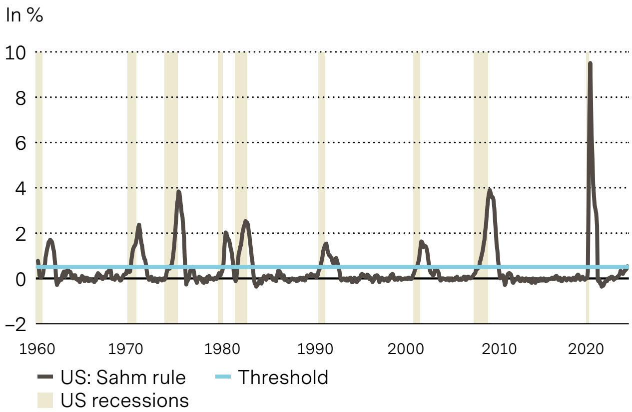
The pressing question now is: when will "winter" (i.e., a US recession) arrive? The official verdict is still pending. The National Bureau of Economic Research (NBER) uses a range of criteria to assess whether the US economy is in recession, and this process typically takes time: on average, between four and 21 months for the NBER to announce the start of a recession.

Chart 1: Consumers are more pessimistic about the labor market



Source: Conference Board, Vontobel; data as of July 2024.

Chart 2: The Sahm rule has been triggered



Source: LSEG, Vontobel; data as of July 2024.

If the "Sahm Rule" (an indicator named after the economist Claudia Sahm), is to be believed, a recession is already on the horizon (see chart 2). This indicator is triggered when the three-month moving average of the US unemployment rate increases by 50 basis points (bps[17]) compared to its 12-month low. It was designed to alert monetary authorities to the early stages of a recession, signaling when action, such as interest-rate cuts, might be necessary. Given that the indicator has been historically accurate, even going back to the 1970's[18], it became a major talking point following the release of the July jobs report.

While the weak labor market data at the beginning of August led to a temporary sell-off in the stock markets, many market participants still seem confident that the Fed will succeed in achieving the much-cited "soft landing" for the economy—that is, bringing inflation down to the Fed's 2 percent target without triggering a recession. This optimism is reflected, for example, in Bank of America's Global Fund Manager Survey. In July, 68 percent of respondents still expected a "soft landing". In August, this figure had risen to 76 percent, as hopes for interest-rate cuts increased following the weak labor market data.

Claudia Sahm herself seems hesitant to declare a recession just yet, emphasizing last month that the US economy was still in a strong position and that it was unlikely that the country was currently in recession[19]. She noted that "this time really could be different. [The Sahm Rule] may not tell us what it's told us in the past, because of these swings from labor shortages, with people dropping out of the labor force, to now having immigrants coming lately. That all can show up in changes in the unemployment rate, which is the core of the Sahm Rule."

We continue to believe that the markets are overly optimistic about economic growth. Regardless of when, or if, a recession is officially declared, the latest data is poised to increase the pressure on the Fed to cut interest rates. At the Kansas City Fed's annual Jackson Hole Economic Symposium, it was evident that Fed members are now also concerned about the deceleration.

According to Fed Chair Jerome Powell, the slowdown in the labor market is "unmistakable" and a further slowdown is neither sought nor welcomed. The time has therefore come for interest-rate cuts.

The tiger as the new dragon?

It's like a tale of old and new economic miracles: China's economy has long been the driving force behind global growth but has been stuttering for some time now. In contrast, neighboring India seems to be running like a well-oiled machine. The International Monetary Fund (IMF) recently raised its gross domestic product (GDP) forecast for India to 7 percent from 6.8 percent for the years 2024 to 2025[20]. This prompts the question: could India (the "tiger") eventually emerge as "China 2.0" and become the new "dragon"?

—
Michaela Huber
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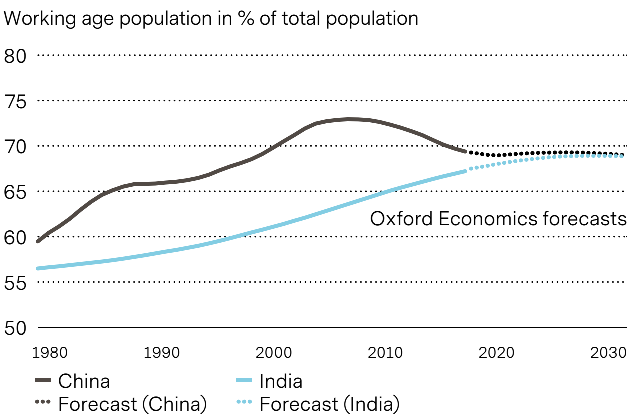
China's GDP, the largest globally in terms of purchasing power parity (PPP)[21], has traditionally relied on industrial production and manufacturing exports. However, the economy faces several stumbling blocks. A domestic property crisis has led to falling house prices and dampened consumer confidence, while geopolitical tensions also play a role. Relations with the US have been strained since the onset of the US-Chinese trade war in early 2018. More recently, relations with Europe have cooled following the announcement of punitive tariffs on Chinese electric vehicles in June 2024.

Meanwhile, India continues to forge ahead. In the fiscal year that ended in March 2024, India's GDP rose 8.2 percent, surpassing the government's forecast of 7.6 percent and cementing its position as the fastest-growing major economy in the world. This strong performance follows a decade of strong growth. When Prime Minister Narendra Modi took office in 2014, India's GDP per capita was USD 1,560; by 2023, it had risen to USD 2,239.

What speaks in favor of a "China 2.0"?
There are many arguments supporting the "Indian growth story". First and foremost, India is very well-positioned demographically. With a population of 1.44 billion, India surpassed China as the world's most populous country in 2023[22]. While India's fertility rate has declined to just over two births per woman, it remains significantly higher than China's rate of 1.17 births per woman[23]. According to forecasts by Oxford Economics, India's labor force is expected to continue expanding in the coming years, whereas China's is projected to shrink (see chart 1).

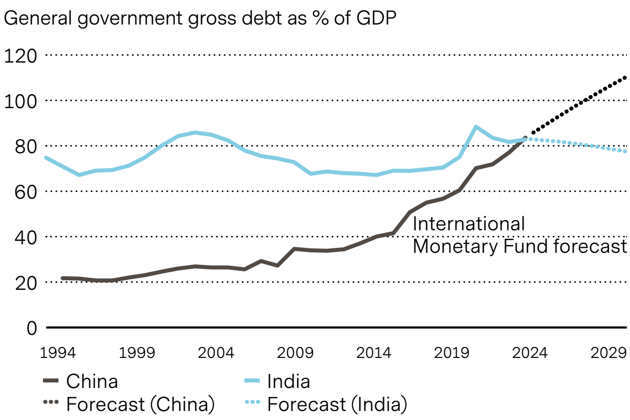
Secondly, India still has considerable potential for urbanization. China's rural population peaked in 1991 and has since been steadily declining as more people have migrated to urban centers. The urbanization trend is still in its early stages in India, with the rural population significantly outnumbering the urban population.

Chart 1: Growing labor force, growing economy?



Source: LSEG, Oxford Economics, Vontobel; data as of August 23, 2024.

Chart 2: India has limited room for stimulus



Source: LSEG, International Monetary Fund, Vontobel; data as of August 23, 2024.

India also seems well-positioned amid the increasing (geo)political fragmentation observed in recent years. One example is the US-China trade war: while the US reduced imports from China and imposed a series of punitive tariffs, India's imports increased, though still a fraction of China's trade volume. Another example is the war between Russia and Ukraine. When Western nations imposed sanctions on Russia in 2022, India, which considers Russia a "strategic partner"[24], chose not to follow suit. Instead, it started to import large quantities of discounted Russian oil.

Comparing apples and oranges

We believe that a direct comparison between the "Chinese economic miracle" and India's economic rise isn't entirely appropriate. China's ascent to economic power was largely driven by its strong manufacturing sector and massive infrastructure investments. In contrast, India's economy is dominated by the services sector, including IT, which accounts for more than 50 percent of the country's GDP. Manufacturing and agriculture make up the remainder.

Although employment in the service sector has increased to 26 percent in recent years, agriculture still employs the majority of the workforce, with 42 percent of workers engaged in this sector, according to the World Bank as of 2022. However, this sector is not necessarily efficient. Despite being the world's second-largest producer of rice, wheat, and cotton, India's crop yields (the amount of a crop produced per unit area) are significantly lower than those of other major producing countries.

Efforts to boost the manufacturing sector, including the government's "Make in India"[25] initiative in 2014, have faced challenges. Since 2014, the manufacturing sector's growth rate has averaged 5.9 percent, falling short of the target of 12 to 14 percent. Manufacturing's share of GDP has also stagnated.

There are several other challenges that India still needs to address. While India has made considerable progress in education, it still lags behind China in literacy rates—the percentage of people aged 15 and over who can read, write, and understand a simple statement about their daily lives. According to the World Bank, India's literacy rate stands at around 76 percent as of 2022, compared to nearly 100 percent in China as of 2020[26].

Additionally, the labor force participation rate of Indian women remains very low. The labor force participation rate is the proportion of the population aged 15 and over that is economically active. According to the World Bank, the labor force participation rate of Indian women

has hovered around 30 percent for decades, while in China, it was over 70 percent in the 1990s and still exceeded 60 percent in 2023[27]. As a result, a significant amount of economic potential remains untapped.

The labor market presents its own set of challenges. While strong population growth can be economically beneficial, it can quickly become a double-edged sword if there aren't enough jobs to absorb the growing workforce. Almost 16 percent of urban youth aged 15 to 29 were unemployed in 2022 – 23[28]. Private estimates paint an even grimmer picture. The Centre for Monitoring Indian Economy, a think tank, estimates India's youth unemployment rate at over 45 percent[29].

We believe that for India to grow further, investments will need to be made. In the early 1990s, China's investments accounted for over 40 percent of GDP. Investment peaked at just under 47 percent in 2010 and remained at 42 percent in 2023. In India, investment stood at 33 percent of GDP in 2023 and is expected to decline in the coming years, according to the IMF. A similar trend is evident in research and development (R&D) spending. According to the World Bank, India's R&D expenditure in 2020 was only around 0.6 percent of GDP, compared to 2.4 percent in China and 3.5 percent in the US.

At the same time, the scope for fiscal or monetary policy stimuli appears to be limited. In 2023, India's public debt was nearly 83 percent of GDP, similar to that of China (see chart 2). In addition, the Reserve Bank of India is required to keep headline inflation at 4 percent, with a tolerance range of 2 percentage points on either side. However, India's inflation has hovered at the upper end of this range for some time, leading the Indian repo rate[30] to remain at 6.5 percent since the beginning of 2023.

India's importance for multi-asset investors
Understanding the broader economic context is only part of the equation. But how relevant is India from an investor's perspective? We've put together some of the key factors to consider for the various asset classes in India:

Equities

Since the 1990s, major equity indices have included India. The country currently accounts for some 2 percent of the MSCI All Country World Index (included since 1994) and around 19 percent of the MSCI Emerging Markets Index (included since 1998). This means that India holds a larger share of the emerging markets index than South Korea (12 percent), and a similar share to Taiwan (19 percent), though still less than China (25 percent).*

A few other things to consider:

1. India's equity market can look back at an impressive rally and is quite highly valued by now—and even more expensive than the US stock market in terms of expected price-to-earnings (P/E) ratio (see chart 3).

2. The equity rally was accompanied by a boom in the equity derivatives market. Futures and options turnover in India reached a record USD 6 trillion in February, up from less than USD 150 billion five years ago[31]. At the end of July 2024, Indian regulators increased the tax rate from 15 percent to 20 percent for shares held for less than one year and from 10 percent to 12.5 percent for shares held for more than one year. The tax on trading in equity derivatives was also increased, raising the securities turnover tax rate from 0.0125 percent to 0.02 percent and on options from 0.0625 percent to 0.1 percent from October.

Bonds

Anyone looking for India in indices such as the Bloomberg Global Aggregate Index will realize that it isn't represented there.

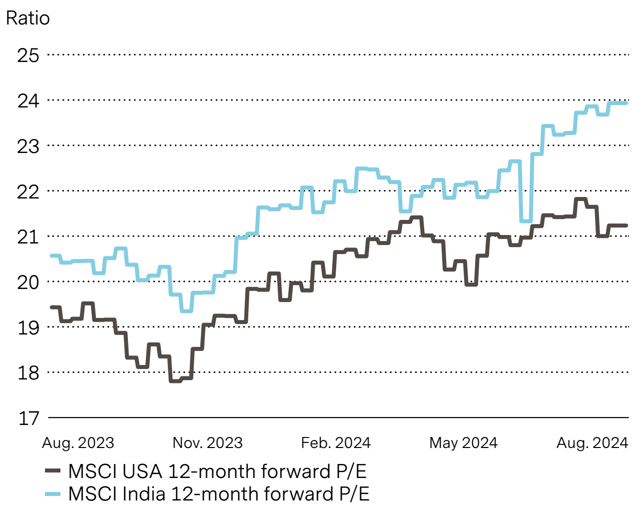
A few things to consider:

1. India's bond market is strictly regulated and has one of the lowest foreign ownership rates among emerging markets. However, some things are likely to change in the future. Index provider JP Morgan included India in its global GBI-EM index series[32] from June 28, 2024.

2. The inclusion is to take place over a period of 10 months (+1 percent each month). Indian bonds could therefore have the highest possible weighting (10 percent) in JP Morgan's emerging markets index by March 2025 and thus be equally weighted as Chinese, Indonesian, and Mexican bonds (see chart 4).

3. However, it remains to be seen to what extent India will open its bond market. In July 2024, the central bank unexpectedly announced, without providing reasons, a ban on foreign investors purchasing newly issued government bonds with maturities of 14 and 30 years, effective immediately[33].

Chart 3: India's stock market is not exactly cheap



Source: LSEG, Vontobel; data as of August 23, 2024.

*Note: Index weightings can change.

Commodities
Can India trigger another "commodity super cycle[34]"?

A few things to consider:

1. The last major super cycle occurred in the 2000s and was largely caused by rising demand from emerging markets, particularly China.

2. India has the potential to have a significant impact on global commodity markets. With the country's large population, growing economy, ongoing industrialization, and urbanization, demand for commodities such as oil, metals, and agricultural products is also likely to increase.

3. However, whether this could trigger a new commodity super cycle depends on a variety of factors, including the pace and extent of India's economic growth, global economic conditions, and the supply response of commodity producers.

Gold
The "Tiger" may also impact gold markets.

A few things to consider:

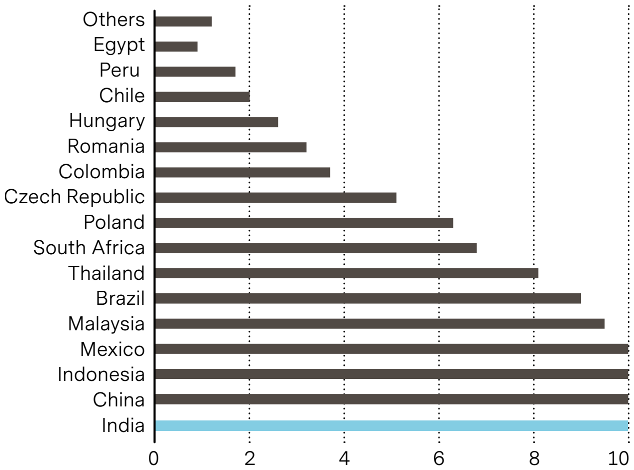
1. Gold holds a special place in Indian culture, where it's considered a lucky charm in Hindu and Jain traditions. Major festivals, such as Diwali, and weddings often feature gold prominently, with weddings alone accounting for around 50 percent of India's annual gold demand, according to the World Gold Council[35]. As household incomes in India rise, demand for gold could increase correspondingly.

2. Since Western countries froze Russian foreign exchange reserves after the Russian invasion of Ukraine, the Indian central bank has been diversifying its reserves by increasing gold purchases (see chart 5).

3. However, other factors also influence gold demand and prices, such as US monetary policy and US dollar developments.

Chart 4: Indian bonds could have highest possible weighting in JP Morgan's flagship EM index*

Estimated weight in GMB-EM Global Diversified Index (in %)

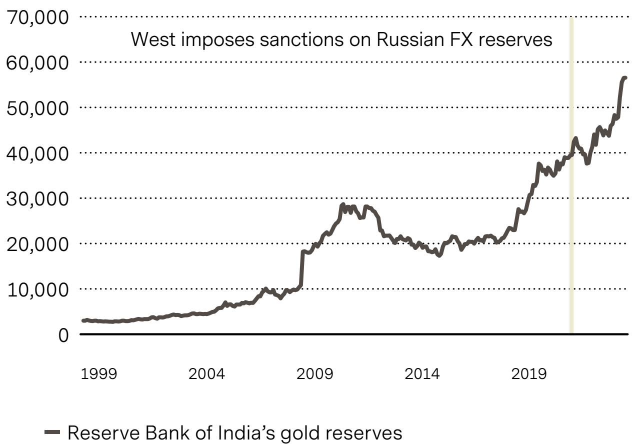


*Note: By March 2025.

Source: Bloomberg, JP Morgan, Vontobel; data as of June 2024.

Chart 5: India's central bank has learned its lesson

In million USD



Source: LSEG, Vontobel; data as of August 23, 2024.

Signals of misaligned Fed rates?

—
Christopher Koslowski
Senior Fixed Income & FX Strategist,
Vontobel

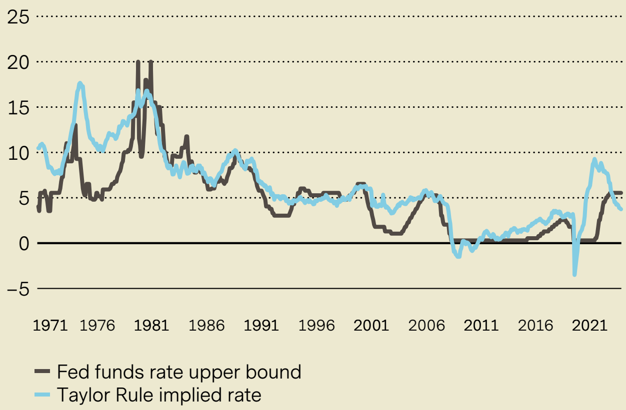
The so-called Taylor Rule[36]—a formula that helps central banks balance their goals of controlling inflation and promoting economic growth by providing a guideline for setting interest rates—suggests the Fed's is currently 1.7 percentage points too high, amid rising unemployment and slowing inflation. With markets volatile and growing expectations of Fed cuts, we maintain our preference for government bonds as monetary policy loosens.

According to the classic Taylor Rule, the current benchmark interest rate set by the Fed is approximately 1.7 percentage points—or equivalent to seven quarter-point cuts—above the appropriate level. This assessment follows an increase in the unemployment rate to 4.3 percent in July and a slowdown in inflation, with the Personal Consumption Expenditures Price Index excluding food and energy rising just 2.6 percent year-over-year in June[37]. Incorporating the Fed officials' estimate of a 0.7 percent "neutral real rate" and a long-run unemployment rate of 4.4 percent, the Taylor rule suggests an appropriate interest rate of about 3.7 percent (see chart 1).

Market-implied rate expectations currently indicate strong confidence in substantial monetary easing over the next year, forecasting a decrease in the overnight rate by at least two percentage points. The fed funds futures market expects this easing cycle will likely conclude with rates stabilizing above 3 percent. This represents a notable shift from the pattern since Paul Volcker's retirement as Fed chairman in 1987, where the trough of the fed funds rate during each easing cycle consistently fell below 3 percent. While there is widespread expectation for imminent rate cuts by the Fed, the market increasingly views the exceptionally low rates of the past three decades as an anomaly. As a result, the consensus is moving towards a future characterized by generally tighter monetary policy.

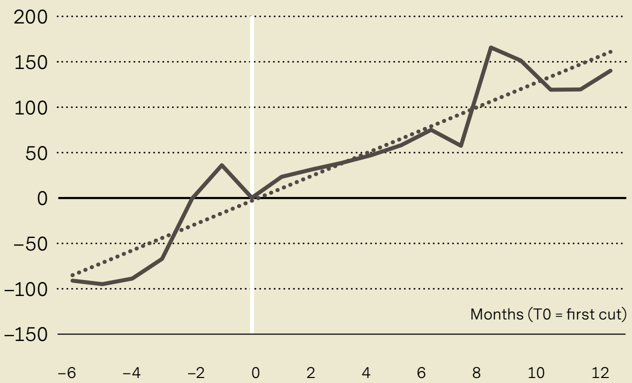
Fed inertia and global unrest fuel credit spread volatility
August saw market turbulence driven by several factors: concerns that the Fed is behind the curve in cutting interest rates, the unwinding of the yen carry trade, a closely contested US presidential race, and ongoing unrest in the Middle East. This resulted in spread widening[38] early in the month, reinforcing our cautious stance on both investment-grade and high-yield credit (see chart 2). While markets were largely priced to perfection, the current volatility has pushed spreads higher, though only to levels seen late last year—and not to levels that would suggest panic selling due to renewed recession fears.

Chart 1: Model based on Fed estimates indicates key rate nearly 170 bps too high
In %



Source: Bloomberg, Vontobel; data as of July 31, 2024.

Chart 2: The start of a cutting cycle is usually associated with spread widening
Average US high-yield spread change in bps over last 30 years (T0 = 0)



Source: Bloomberg, Vontobel; data as of July 31, 2024.

Equities' whirlwind ride

—
Mario Montagnani
Senior Investment Strategist,
Vontobel

This summer took investors on a whirlwind ride. While Europe faced stormy weather and Hurricane Beryl ravaged the Caribbean and the US Gulf Coast, similarly, after reaching an all-time high by mid-July, stock markets encountered a perfect storm in an already weak seasonal period, leading to a spectacular global sell-off. Equities nearly entered correction territory by early August but quickly rebounded. Where might markets go from here?

July saw plenty of headlines on the US presidential election and escalations in the Middle East and Eastern Europe conflicts. By mid-July, investor sentiment was dampened by a softer-than-expected second-quarter reporting season, high expectations from a strong first half-year and stretched valuations. Uninspiring comments from large US tech companies about the longer-than-expected time to monetize AI investments and sustained capital expenditures ignited a rotation out of tech leaders into small caps and value stocks.

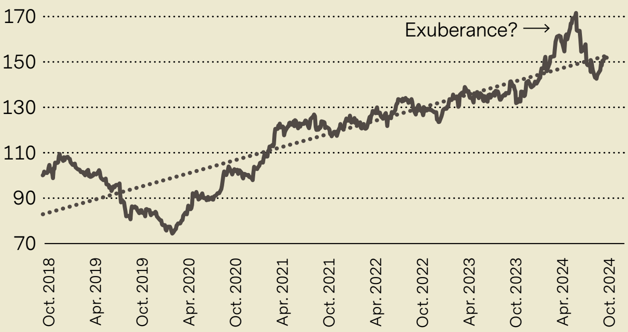
By end-July, disappointing US job figures raised fears that the Fed was again behind the curve in cutting rates, reviving recession concerns. This, combined with a surprise rate hike from the Bank of Japan, triggered a massive unwinding of leveraged yen positions, creating perfect storm conditions. The resulting global sell-off affected all risky assets, particularly equities, with "fear gauges" like the Chicago Board Options Exchange's Volatility Index (VIX) reaching levels only surpassed by the 2008 Lehman Brothers collapse and the 2020 Covid-19 outbreak.

We believe equity markets were ripe for a short-term correction this summer, given the record-breaking performance in the first half of 2024, extreme bullish positioning, rich valuations, and ambitious earnings expectations for US tech stocks. The market shake-up last month has been beneficial for market breadth, with the exuberance of mid-July now under control (see chart 1). In fact, we view this recent correction as a healthy consolidation within a longer-term uptrend.

Historically, a 10 percent correction is not unusual, even more so given the traditionally weak seasonal period (see chart 2). Additionally, S&P 500 Index companies have emerged from their buyback blackout period, which should support the market. With technical concerns now addressed, the focus shifts to fundamentals. Growth and earnings momentum remain strong, as evidenced by the latest reporting season and corporate outlooks.

Chart 1: Magnificent exuberance

Relative performance in %, indexed to October 15, 2018 (=100), in USD



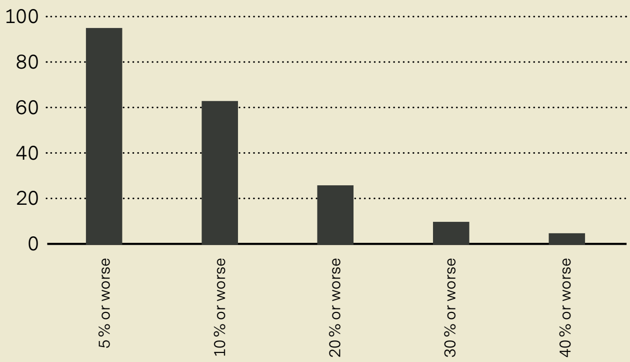
"Magnificent 7*" relative performance to remaining of S&P 500 Index Ex-Technology
Linear trend

* Magnificent 7: Nvidia, Apple, Microsoft, Alphabet, Amazon, Meta, Tesla

Source: Bloomberg, Vontobel; data as of August 23, 2024.

Chart 2: Probability of stock market pullbacks over the last century

Probability per year in %



Source: Bloomberg, Vontobel; data as of August 23, 2024.

From “Cruel Summers” to enduring “Love Stories”

—
Michaela Huber
Senior Cross-Asset Strategist,
Vontobel

Some readers may have found themselves at Zurich’s Letzigrund stadium (or elsewhere) this summer, swept up in the pop culture phenomenon that is Taylor Swift, perhaps dragged there by their children. Swift’s catchy songs, however, offer more than just entertainment; they also provide an apt metaphor for the current state of the commodities markets.

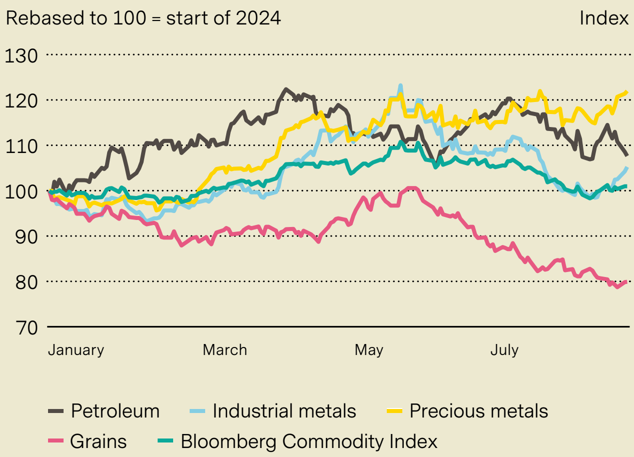
Commodities’ year-to-date performance can best be summed up as “Back to December”. After an initial rally, the Bloomberg Commodity Index has returned to where it was in December 2023 (see chart 1).

For several commodities, it has indeed been a “Cruel Summer”. Agricultural commodities, which make up almost 27 percent of the index, have struggled with bumper harvests (oversupply). Base metals, accounting for just under 16 percent of the index, have been weighed down by subdued industrial demand and economic uncertainty in China, a major metals consumer.

While oil prices were initially buoyed by geopolitical factors and seasonal demand, the outlook appears less rosy. China, the world’s largest oil importer, is reducing imports. With the driving season coming to a close and inventory draws tapering off, even the Organization of the Petroleum Exporting Countries and its allies (OPEC+)—typically bullish—has cut its global oil demand forecasts[39]. Much now hinges on the group’s future production policies. OPEC+ is currently withholding around 5.7 percent of global supply but plans to gradually return 2.2 million barrels per day to the market in the fourth quarter[40]. However, given the uncertain demand outlook, it remains to be seen if these cuts will be reversed. Yet, the pressing question on many minds is: “Is it (really) over now?”. In the absence of major shocks, Brent crude oil prices are likely to stay between USD 70 to USD 80 per barrel. With OPEC’s recent forecast cuts, driven partly by China’s economic situation, we think further production cuts may be on the horizon to support prices.

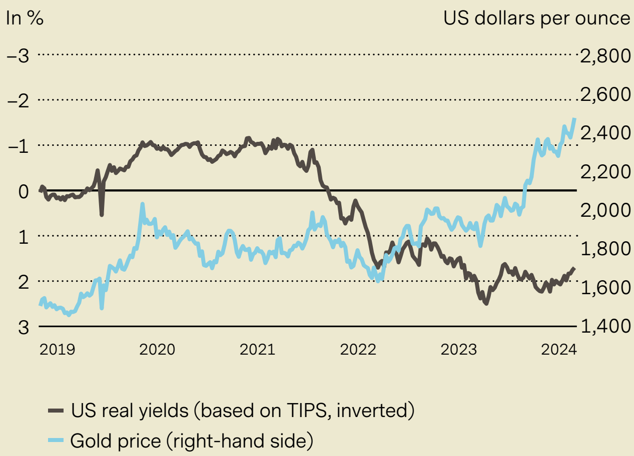
Meanwhile, investors continued their “Love Story” with gold, which makes up 17 percent of the index. After an already impressive rally, the precious metal reached a new all-time high of over USD 2,500 per ounce in August[41]. Interestingly, the factors that have driven gold demand in the recent past—such as central bank and emerging market demand—seem to be losing their importance. Markets shrugged off news that the People’s Bank of China had halted its gold reserve buying and remained unfazed by reports of a decline in Chinese gold imports for non-monetary purposes in July[42] (“Shake it off”). Instead, traditional macroeconomic drivers like US real yields and the US dollar have returned to center stage (see chart 2). We believe our expectation for lower US real yields and a weaker US dollar argues for maintaining a slight overweight.

Chart 1: “Back to December” for commodities



Source: LSEG, Bloomberg, Vontobel; data as of August 22, 2024.

Chart 2: Macro matters again



Source: LSEG, Vontobel; data as of August 22, 2024.

Euro-dollar prospects brighten as franc stability faces tests

—
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Senior Fixed Income & FX Strategist,
Vontobel

Weak US economic data has lifted expectations of faster Fed easing, potentially pushing the euro-dollar exchange rate sustainably above USD 1.10 depending on global risk sentiment and improvements in the Eurozone. In Switzerland, a strong franc challenges exports, which may lead the Swiss National Bank (SNB) to consider further rate cuts to curb the currency's rise amid limited interventions.

Euro-dollar bulls have been bolstered by recent disappointing US economic data, including the weak July 2 employment report, which fueled expectations of faster easing by the Fed (see chart 1). This has pushed the euro-dollar above USD 1.10. However, the strength and duration of any rally will also depend on a resurgence in global risk appetite and positive developments in the Eurozone. Continued improvement in the Eurozone's economic environment could narrow the current and expected euro-US growth differential, supporting a sustainable break of the USD 1.10 mark.

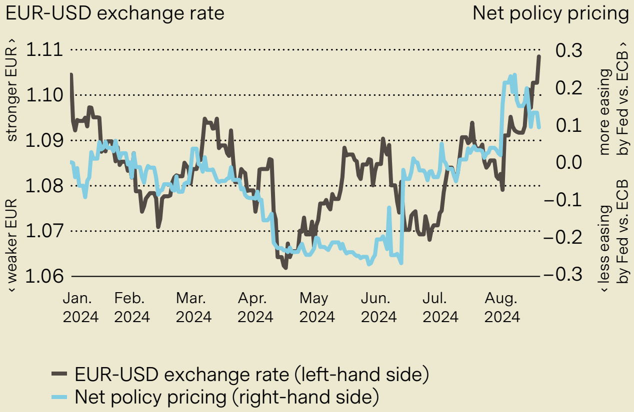
Continued equity market jitters could spoil euro-dollar upside if persistent and if it eventually translates into a broad risk-off market sentiment with associated safe-haven flows.

Swiss economy at the mercy of the mighty franc
The Swiss economy, which is heavily reliant on exports, is highly sensitive to currency fluctuations. With inflation concerns easing, the strong franc could pose challenges for exporters, particularly small and medium-sized businesses. Swissmen, the leading advocacy group for manufacturers in the country, has recently urged the SNB to intervene, cautioning that the strong franc is detrimental to the economy.

The deflationary environment, coupled with the tightening effects of a stronger currency, has reignited expectations for rate reductions by the SNB in September. The SNB began its easing cycle with a 25-bps reduction in March, followed by another 25-bps cut in June. Bloomberg Economics anticipates further cuts of 25 to 50 bps by year's end . While these measures might limit further appreciation of the franc, they are unlikely to significantly alter the course of its rally, which is driven by global market uncertainties.

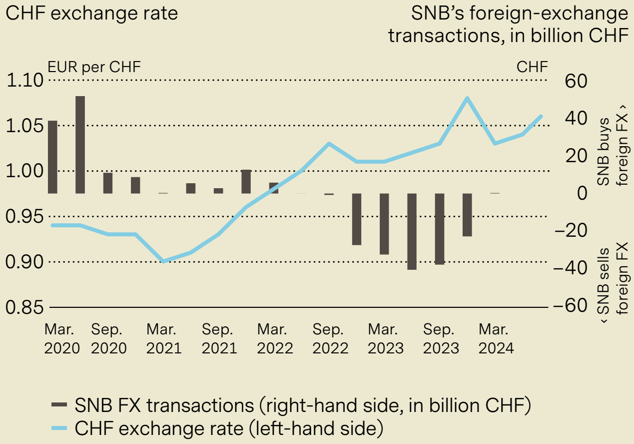
Although foreign exchange (FX) intervention remains a possibility, the SNB has been relatively inactive in this area this year, having acquired only CHF 281 million in foreign reserves in the first quarter (see chart 2).

Chart 1: US rate expectations take a turn



Source: Bloomberg, Vontobel; data as of August 19, 2024.

Chart 2: SNB's quiet quarter: minimal intervention despite potential market moves



Source: Bloomberg, Vontobel; data as of August 19, 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	3.0	3.0	2.5	2.6
Eurozone	3.4	0.4	0.6	0.7	1.4
USA	1.9	2.5	3.1	2.3	1.7
Japan	1.0	1.9	–0.8	0.1	1.2
UK	4.5	0.3	0.3	1.0	1.3
Switzerland	2.7	0.7	0.8	1.3	1.4
Australia	3.8	1.9	2.1	1.2	2.1
China	3.0	5.2	4.7	4.9	4.5

INFLATION	2022	2023	CURRENT[2]	2024 CONSENSUS	2025 CONSENSUS
Global (G20)	7.5	4.4	5.6	4.9	3.1
Eurozone	8.4	5.5	2.6	2.4	2.1
USA	8.0	4.1	2.9	3.0	2.4
Japan	2.5	3.3	2.8	2.4	1.9
UK	9.1	7.3	2.2	2.6	2.2
Switzerland	2.8	2.2	1.3	1.3	1.1
Australia	6.6	5.7	3.8	3.4	2.8
China	2.0	0.2	0.5	0.5	1.5

KEY INTEREST RATES (IN %)	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR	2.50	4.50	4.25	3.40	2.65
USD	4.50	5.50	5.50	4.75	4.00
JPY	–0.10	–0.10	0.23	0.35	0.59
GBP	3.50	5.25	5.00	4.65	3.75
CHF	1.00	1.75	1.25	0.95	0.89
AUD	3.10	4.35	4.35	4.30	3.70

GOVERNMENT BOND YIELDS, 10 YEARS (IN %)	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR (Germany)	2.6	2.0	2.25	2.26	2.23
USD	3.9	3.9	3.85	4.03	3.92
JPY	0.4	0.6	0.90	1.10	1.30
GBP	3.7	3.5	3.96	3.80	3.63
CHF	1.6	0.7	0.45	0.62	0.84
AUD	4.1	4.0	3.92	4.09	3.91

FOREIGN EXCHANGE RATES	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
CHF per EUR	0.99	0.93	0.95	0.96	0.99
CHF per USD	0.94	0.84	0.85	0.88	0.89
CHF per 100 JPY	0.72	0.60	0.58	0.60	0.62
CHF per GBP	1.12	1.07	1.12	1.13	1.16
USD per EUR	1.06	1.10	1.11	1.10	1.12
JPY per USD	130.00	141.00	146.00	148.00	143.00
USD per AUD	0.67	0.68	0.67	0.68	0.69
GBP per EUR	0.88	0.87	0.85	0.85	0.85
CNY per USD	6.91	7.10	7.14	7.20	7.16

COMMODITIES	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
Brent crude oil, USD per barrel	86	77	78	83	81
Gold, USD per troy ounce	1,824	2,063	2,499	2,400	2,500
Copper, USD per metric ton	8,372	8,559	9,131	9,900	9,990

[1] Latest available quarter
[2] Latest available month, G20 data only quarterly
Source: Vontobel, respective statistical offices and central banks; as of August 23, 2024

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Glossary and sources

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[2] Approach where investors are willing to take on more risk in pursuit of higher returns.
[3] Overweight means the Vontobel Investment Committee has a higher preference for an asset class or sub-asset class.
[4] Source: Fed Chair Jerome Powell's speech, August 23, 2024. www.federalreserve.gov/newsevents/speech/powell20240823a.htm
[5] Source: ING article, published July 24, 2024. think.ing.com/snaps/eurozone-jul24-pmis/
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[16] The core unemployment rate excludes temporary or cyclical factors, such as economic recessions or expansions.
[17] One basis point is equal to one one-hundredth of a percentage point, or 0.01%.
[18] Source: JPMorgan article, published August 8, 2024. privatebank.jpmorgan.com/nam/en/insights/markets-and-investing/what-is-up-with-the-sahm-rule-and-what-does-it-mean-for-the-fed
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[23] Source: World Bank, data.worldbank.org/indicator/SP.DYN.TFRT.IN?locations=IN
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[25] The "Make in India" initiative, introduced in 2014, aims to promote the country as a preferred global manufacturing destination. Ministry of External Affairs: www.mea.gov.in/Images/attach/Make_in_India_Initiative.pdf
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[28] Source: DW article, published May 7, 2024. www.dw.com/en/india-high-youth-unemployment-poses-massive-challenge/a-69018952#:~:text=youth%20unemployment%20rate.-,Nearly%2016%25%20of%20urban%20youth%20in%20the%2015%2D29%20age,at%20as%20high%20as%2045.4%25.
[29] Source: LiveMint article, published May 29, 2024. www.livemint.com/economy/indias-youth-unemployment-rate-among-highest-in-world-says-ex-cea-netizens-call-it-heights-of-propaganda-11716977982254.html
[30] Interest rate at which a central bank lends money to commercial banks for short periods, usually overnight, in exchange for securities.
[31] Much of this growth is due to the introduction of weekly expiry contracts (2019), replacing the traditional month-end expiry dates. The main advantage of shorter maturities is that the probability of a loss for the seller is lower, and they therefore cost less.
[32] Source: Invest India article, published October 23, 2023. www.investindia.gov.in/team-india-blogs/indias-inclusion-jp-morgans-government-bond-index-emerging-markets-gbi-em-index
[33] Reuters article, published July 30, 2024. www.reuters.com/markets/rates-bonds/foreign-investors-unhappy-after-india-restores-curbs-some-bond-purchases-2024-07-30/
[34] A commodity super cycle is a prolonged period in which commodity prices are significantly above or below their long-term trend. It is usually triggered by a surge in demand, often due to industrialization and urbanization in emerging markets.
[35] Source: World Gold Council. www.gold.org/about-gold/gold-demand/geographical-diversity/india#:~:text=Gold%20is%20central%20to%20more,annual%20gold%20demand%20in%20India.
[36] Introduced by economist John Taylor, the Taylor Rule is a guideline for adjusting the federal funds rate (overnight bank lending rate). It suggests raising the rate when inflation is projected to be above normal and lowering it when GDP growth is expected to be below normal, assuming other factors remain constant.
[37] Source: Bloomberg article, published July 26, 2024. www.bloomberg.com/news/articles/2024-07-26/fed-s-preferred-inflation-gauge-rose-at-mild-pace-in-june
[38] Increase in the difference (spread) between yields.
[39] Source: Reuters article, published August 12, 2024. www.reuters.com/business/energy/opec-cuts-2024-oil-demand-growth-forecast-citing-china-2024-08-12/
[40] Source: Reuters article, published August 1, 2024. www.reuters.com/business/energy/opec-likely-stick-output-policy-meeting-sources-say-2024-08-01/
[41] Source: CBS News article, published August 13, 2024. www.cbsnews.com/news/golds-price-surpasses-2500-an-ounce-moves-to-make-now/
[42] Source: Bloomberg article, published August 20, 2024. www.bloomberg.com/news/articles/2024-08-20/china-s-gold-imports-tumble-again-as-record-prices-deter-buyers

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