Vontobel

Investors' Outlook

"Tina" waved good-bye, but don't slam the door on stocks

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* see page 17 “Legal information”: analyst confirmation

"Tina" waved good-bye, but don't slam the door on stocks

—
Dan Scott
Head of Vontobel Multi Asset, Vontobel

Dear readers,

"There is no alternative (to stocks)" used to be the mantra on financial markets in the past few years. No longer. Higher-than-expected inflation and central banks' frantic countermeasures have sent share valuations and prices south. In voting with their feet, equity investors have waved "Tina" good-bye.

They can't be blamed. A long-forgotten scourge of people's lives has reared its ugly head—yes, a brutal war in Europe, and that's troubling enough. But perhaps as important in market terms, inflation. Gone are the days of ultra-cheap fuel or food. Decades of easy money and more recent developments such as deglobalization or the energy transition have brought a wave of rising prices, denting household budgets, and giving rise to all kinds of inventive ways to save a dollar – even instructions how to siphon off fuel from somebody else's car recently aired on Greek television.

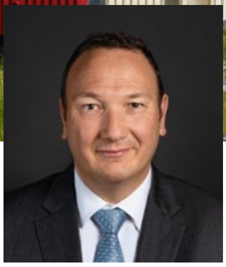
During past crises, investors often took comfort in the relative shelter a balanced portfolio of equities and bonds provided. But it was different this time. Bonds, meant to shield us from an equity market downturn, sold off in tandem. The only asset class to do well so far this year has been commodities.

In April, I suggested that investors rethink the bond part of a traditional 60 / 40 portfolio, allocating larger amounts to strategies that held their their own, for instance gold and commodities. This still holds true, but what to do about the bigger chunk of a model portfolio, equities, that investors simply cannot do without? True, rocketing consumer prices and tighter monetary policies are hardly a draw. That said, we think that central banks will be successful in bringing inflation lower. Moreover, we have already seen first signs of the so-called demand destruction – a markedly lower uptake that will eventually drag prices down.

A neutral view on equities is reasonable given that we neither expect a broad and severe global recession, nor do we have enough evidence of a soft landing yet. Our positioning within this asset class remains defensive but it's worth noting that after the sell-off, there are pockets in global markets that are looking appealing. From our point of view, it's high-quality companies with solid free cash flows or, for those with a higher risk appetite, the biotechnology sector.

Take a fresh look after your holiday
It's probably safe to say that no matter what, inflation will stay with us as the number one topic at summer barbecues, eclipsing the weather as a conversation item. So do enjoy the summer, go to lakeside parties in Zurich or elsewhere, keep talking about the high price of everything but don't completely forget the "buy" key on your laptop. The moment to re-engage may come near or past the point of peak inflation and "peak hawkishness" on the part of central banks. In the meantime, stay invested and take a fresh look when you come back from holiday.

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



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Small changes within bonds as central banks spring a surprise

In an increasingly divided world, it is a hopeful sign that differences are sometimes resolved in a peaceful manner. The recent settlement of a territorial dispute between Canada and Denmark's autonomous province of Greenland (pictured: the capital Nuuk) over the uninhabited island Hans is a fine example.

Unfortunately, things haven't been very peaceful in Europe, nor on most financial markets. For the US Federal Reserve, June will probably go down as the month of the "great awakening" to the reality of inflation. The world's most powerful central bank riled markets with a rate hike of 75 basis points (bp) some observers called brutal. Even the Swiss National Bank, usually not one to get ahead of its powerful European peer in Frankfurt, surprised with an increase of 50 bp. If we add to that a probable upward move by the European Central Bank over the summer months, we will be looking at the "hiking year of 2022"—not a good environment for investors. Some respite could follow next year, we reckon, with the US Fed likely to tone down its inflation-fighting rhetoric. And once "hawks" release their grip on monetary policy, interest rates will start moving lower again.

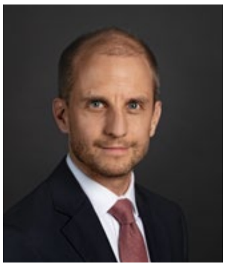
Expectations of this easing scenario materializing some nine months from now, which also reflect growing recession fears, direct our gaze towards fixed income. We made some changes on sub-asset class level, for example upgrading investment-grade corporate bonds from underweight to neutral. This is, among others, due to our belief that higher-quality bonds should outperform lower-quality ones when economic growth rates come down. Further, a more guarded outlook for the US economy prompted us to reduce high-yield bonds from neutral to underweight. Apart from these changes, we retained our overall positioning in all asset classes. Details can be found on the overview page 5 or the asset class-focused items on pages 12 to 15.

	UNDERWEIGHT significantly	UNDERWEIGHT slightly	NEUTRAL	OVERWEIGHT slightly	OVERWEIGHT significantly	
1 Liquidity			→			Our cash positioning remains neutral, as does our overall market risk view. Only rising risks would justify an increased cash position, in our view.
2 Bonds			→			The neutral view on bonds we adopted in late May remains in place, but we are implementing two changes at sub-asset class level. As we now pencil in a higher probability of a global recession and given our outlook for the US economy, which we expect to shrink in 2023, we reduced high-yield bonds from neutral to underweight. At the same time, we upgraded investment-grade (IG) corporate paper from underweight to neutral as we believe higher-quality bonds should outperform lower-quality ones when economic growth falters. Apart from that, we reiterate our favorable view on government bonds and selected emerging-market debt.
3 Equities			→			Our neutral stance on equities and all regional views are confirmed. High inflation and tighter monetary policies that go with it have made the path ahead more challenging. With these aspects now beginning to affect economic growth, analysts have started to revise their earnings estimates downwards. Having said that, we think that a neutral view on equities is still reasonable as long as a broad and severe global recession remains an unlikely scenario. Looking at equity multiples and comparing the current equity market drawdown, i.e. the fall from the highest price point to the lowest, with past drawdowns, we see that a lot of bad news is already priced in. Previous market downturns of more than 35%—we're still nowhere near that mark at the time of writing—have either been short-lived or have ended in a systemic crisis, which we don't expect to occur. A non-cyclical stance seems prudent in such a situation, suggesting an overweight in US and Swiss stocks as well as an underweight in euro zone and Japanese peers. We also keep our neutral view on emerging-market shares.
4 Gold				→		We retain a slight overweight in gold. The probable slowdown in economic growth and rising inflationary pressures should give the yellow metal a boost given its diversification and hedging qualities, which are also important in the context of Russia's invasion of Ukraine. Our expectation of a weaker US dollar also supports a positive gold view as one often rises when the other one falls, and vice versa.
5 Commodities			→			In late May, we decided to lock in some profits by reducing commodities from overweight to neutral, arguing that the asset class's cyclicality, i.e. the tendency to mirror economic developments, would start offsetting its attractive long-term prospects. This assumption proved correct. Over the course of the last month, we saw natural gas and most metal prices correct by around 15%. Some agricultural commodities such as wheat, down by more than 10%, also weakened. As we expect more headwinds for the world economy, we continue to feel comfortable with a neutral view on commodities for the time being.
6 Alternative strategies			→			We keep alternative investments on neutral. This overall assessment comprises a modest underweight in hedge funds and a neutral view on other types of alternative investments such as real estate.

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

We still expect a modest, short-term global rebound while recession risks rise

The April-to-June period was probably the weakest quarter of the year. We still expect a rebound from the current trough, but the recovery could be less dynamic than what we had hoped for. China's lockdowns, the war in Ukraine, and high inflation are taking a toll on consumption and production. With an inflation-fighting job on their hands, central bankers don't even think about signaling a pause in their hiking cycles to help the economy. At least for now.

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Anecdotal evidence of planes or trains getting more crowded has been borne out by international travel data pointing to a return to pre-pandemic levels of global tourism activity. Further positive headlines include early signs of a Chinese economic rebound on the back of an ongoing post-pandemic reopening, as well as increased government spending in China, Europe, and Japan. So much for the good tidings—there's plenty of bad ones. For example, the war in Ukraine or the disruptions of Russian gas supply to Europe, which look set to keep energy prices high for longer, not only in Europe but also globally. As wage increases are unlikely to keep pace with the rise in prices, households' real income and consumption are falling. Moreover, central bankers will remain in policy-tightening mode for months to come (see chart 1). We expect that such a cocktail will slow down growth—after a brief tick higher over the summer months—and increase the probability of a global recession in 2023. This, however, is currently not our base case for the world's economy, though we forecast a contraction in the US in mid-2023. Among the growing risks we see are prospects of declining demand and economic activity in industrial countries (see chart 2). Further potential stumbling blocks include Russia's invasion of Ukraine, continued partial lockdowns in China, and the possibility of central banks getting more rather than less restrictive. All in all, if inflation doesn't heat up even further and growth rates start diminishing significantly in the autumn, we think that central banks may signal a slowdown or a pause in the tightening cycle towards the end of the year. But we aren't there yet.

Europe: Central bankers have finally woken up
After the Bank of England and the US central bank started their rate hiking cycle in November 2021 and March 2022 already, the Swiss National Bank in a surprise move raised its policy rate by 0.5 percentage points in June. Late it may have been, but the SNB still got ahead of the European Central Bank (ECB), where a first step higher is penciled in for July. We reckon that the ECB's main yardstick, the deposit rate, will reach +0.75% by the end of the year versus –0.5% currently. Switzerland's monetary authority is likely to take more upward steps during the next two quarters, which would propel the key rate to +0.5% in December, according to our forecasts. Generally, central banks feel the squeeze of having to tame inflation (we estimate an annual rate of 7.3% for 2022 in the euro zone) via higher key rates while being perfectly aware of the negative consequences on economic growth such actions produce. Some extra uncertainty stems from the war in Ukraine, or more precisely, the possibility of Russia stopping gas deliveries to Europe, which would quickly result in a recession on the continent. On the other hand, inflation alone already weakens consumption, and the

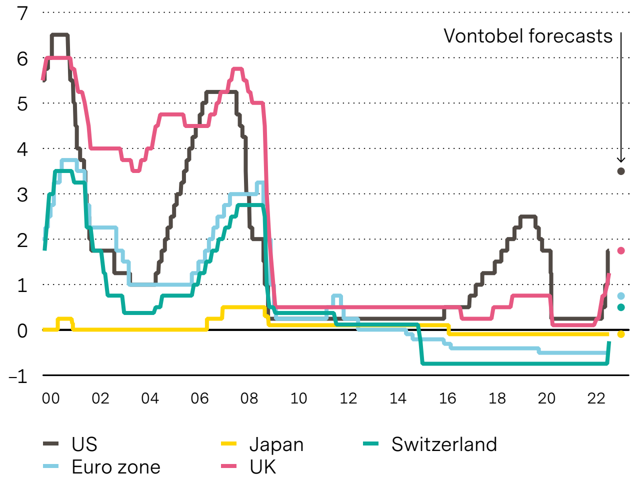
higher key rates now also push interest rates for mortgages and company loans slowly upwards, also denting household and company budgets. We see a modest recovery of the European economy over the summer but expect weakening growth rates towards the end of 2022 and during 2023.

US: A recession in 2023 is now our base case
US consumers have to grapple with a lot of negative factors right now, ranging from rising mortgage refinancing costs as well as higher fuel and energy bills to generally higher costs of living due to sky-high inflation. It's no surprise that consumer sentiment has recently fallen to the lowest level since the 1980s. One positive factor is still the labor market, where job openings remain elevated and wage growth is firmly rising—helping consumption despite the rising costs. Meanwhile, rising prices remain a headache with headline inflation hitting another record high of 8.6% in May. The spike motivated the US Federal Reserve to hike rates aggressively by 0.75 percentage points at its June meeting—the largest rate increase in almost 30 years. The US Fed's resolve to bring prices down remains unconditional, and the central bank anticipates more hikes totalling 1.75 percentage points until the end of the year. We now see the US economy slowing more rapidly during the second half of the year, and entering a mild recession by the second quarter of 2023. More persistent inflation dynamics is a risk that could induce a deeper contraction, but we don't see this happening at the moment.

Japan: The last "dove" standing
If monetary tightening is the name of the game, the Bank of Japan (BoJ) is a notable spoilsport. It hasn't moved one iota from its dovish stance expressed by massive liquidity injections. After years of trying, the central bank's inflation target has finally been reached with consumer prices rising above 2% in April. However, the BoJ considers this uptick unsustainable and is ready to retain its accommodative bias. Whether or not the monetary authority will remain "the last dove standing" remains to be seen given growing pressure at home and abroad.

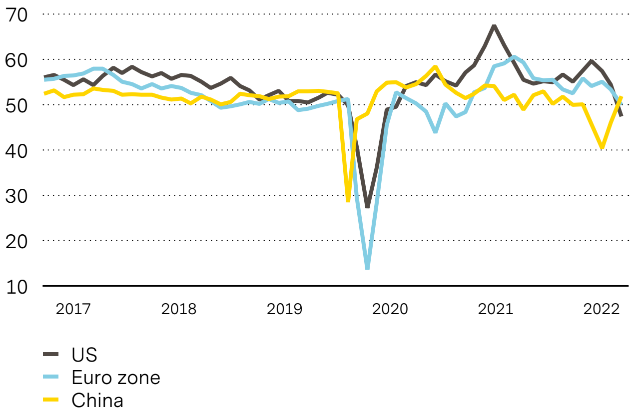
Emerging markets / China: Middle Kingdom goes its own way
Emerging-market central banks, which turned restrictive long before developed-market ones, may continue to tighten the screws. This, alongside a more guarded fiscal course following massive Covid-related support in many emerging economies, is likely to dampen the growth rate to slightly above 3% in 2022, well below the ten-year average of 4.5%. Further negative factors include high commodity and consumer prices with the latter apparently taking aim at a year-end mark of 7.3%, the highest level since the late 1990s except in 2008. However, China promises to be a major exception. Its pro-growth stance since late 2021 looks set to trigger a growth recovery, we believe. In May, Chinese car sales and industrial production surprised to the upside, and real-estate transactions have been stabilizing for some time (see chart 3). Considering global headwinds (e.g. commodity prices) the recovery is likely to remain shallow, which is why we only forecast a rebound to 4.3% in 2022 and 4.8% in 2023.

Chart 1: After years of ultra-low key rates, central banks are expected to raise them aggressively
Central bank's key rates in %



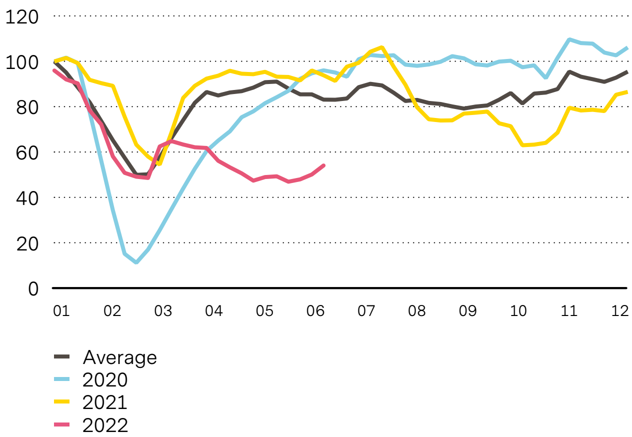
Source: US Fed, ECB, BoJ, BoE, SNB, Refinitiv Datastream, Vontobel

Chart 2: US and euro zone companies expect new orders to decline but Chinese ones are improving
Purchasing managers' index (new orders)*



* A level above the 50 mark points to growth, below 50 to contraction
Source: S&P Markit, Refinitiv Datastream, Vontobel

Chart 3: The Chinese real-estate market seems to be stabilizing
Transaction volumes (rebased to 100 at the start of 2022)



Source: Refinitiv Datastream, Vontobel

Tired of being hooked on Russian gas? Try smart technology solutions

—
Pascal Dudle
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—
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Vladimir Lenin believed that "Soviet power plus the electrification of the whole country"[1] would let communism triumph over capitalism. For his namesake in today's Kremlin, turning off the gas tap is one way of letting the west feel his muscle. There are alternative gas sources, but swapping a warlike supplier for other, more reliable ones can't be the end goal. The focus has shifted to technological solutions.

Unfortunately, the west has long been hooked on the gaseous stuff from Moscow. Germany, in particular, has been in love with the idea of promoting democratic values through close trade relations with Russia. European utility companies, lulled by the steady and increasing flow of Siberia-sourced energy, have been telling consumers that gas is the most eco-friendly option when it comes to fossil fuels, a view recently supported by the European Union. A plan presented by the European Commission earlier this year—shortly before Russia invaded Ukraine—earmarked natural gas for a "green power" label.[2]

There has been a rude awakening. Vladimir Putin is shutting off supplies to the Old Continent. Europe, suddenly aware of the strings attached to the eastern power's gas shipments, is now attempting to wriggle out of the Russian bear's warm embrace.

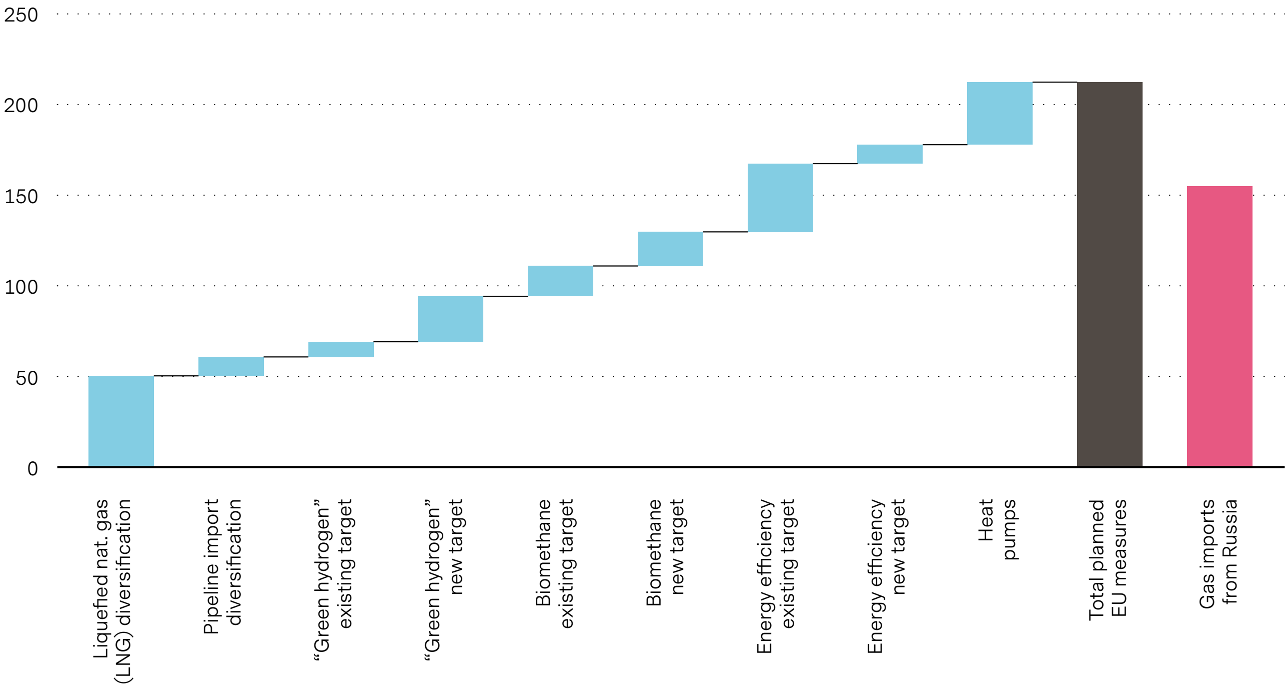
[1] Vladimir Lenin, report on the work of the council of people's commissars, December 22, 1920 (original source: "Polnoe sobranie sochinenii," Moscow 1975-79, Vol 36, pp. 15.16, found in "Seventeen Moments in Soviet History: An Online Archive of Primary Sources," James von Geldern, Lewis Siegelbaum, and Amy Nelson, Macalester College and Michigan State University. https://soviethistory.msu.edu/

[2] "Questions and Answers on the EU Taxonomy Complementary Climate Delegated Act covering certain nuclear and gas activities", the European Commission, February 2, 2022 https://ec.europa.eu/commission/presscorner/detail/en/QANDA_22_712

Energy independence is a priority
Russian gas imports covered approximately 40% of European gas consumption in 2021. To replace them by 2030, the European Commission introduced several measures in its so-called “Repower EU” action plan aimed at gaining energy independence. Under this scheme, the 27-nation bloc will rely on some new pipeline-based imports from countries such as Norway, and more liquefied natural gas (LNG) from various regions.

The small European nation of Lithuania has already weaned itself completely off Russian gas by building an LNG terminal in the Baltic Sea. Germany is planning four LNG platforms with one off the northern city of Hamburg possibly ready by the end of the year.[3] But simply swapping one gas supplier for another won’t do the trick. Smart energy and efficiency solutions are even more important aspects of the Repower EU plan (see chart 1).

Chart 1: The European Union plans a range of measures to become independent of Russian gas
In billions of cubic meters of gas *



* Or EU measures in equivalents
Source: Bank of America, Vontobel

[3] «Bundesregierung plant drei Milliarden Euro für schwimmende LNG-Terminals ein – Hamburg bietet sich als Standort an», Handelsblatt, May 1, 2022

Heat pumps need power but reduce gas demand
We believe that heat pumps in particular are a key technology for buildings, both from a net-zero emissions and a European energy security perspective. Such products that extract thermal energy from the air or the ground, reduce consumers' gas consumption and consequently, carbon emissions. One of the companies we follow in this area is a Sweden-based manufacturer of heat pumps and intelligent indoor climate control systems used in a variety of building types. The company's Climate Solutions division, of which heat pumps are a part, accounts for 74% of overall revenues.

While the company's prospects seem bright under European energy plans and climate targets, there are uncertainties too. Much of its revenue generation in the heat pump sector depends on governments' willingness to subsidize installation in private homes. Moreover, heat pumps consume electricity, and whether or not the power source ticks the right green boxes and has capacity to fully substitute for gas varies from country to country.

The challenges of energy transition
Will the recent developments prompt us to kick our fossil fuel habit and embrace renewable sources of energy as well as innovative products? This is a sensitive issue because it would require a major change in industrial processes as well as our own behavior. Some high-profile European politicians such as Italian Prime Minister Mario Draghi and Robert Habeck, Germany's minister for economic affairs and climate action, have made it clear such a fundamental change will involve personal sacrifices—like switching off air conditioning in the summer due to a possible lack of gas-generated electric power,[4] or turning down heating in the winter because of gas delivery disruptions.[5]

Other challenges of a transition from a fossil fuel-dependent economy to a renewables-based one include the higher use of metals that a massive build-up of solar plants or wind farms would bring. According to the Bank of America, an electric car has six times the mineral requirements per vehicle of a car with a combustion engine, and wind power a mineral-content multiple between nine and 13 times compared with a gas power plant. Some critical minerals—silicon in solar cells, rare earth metals for wind turbines—are already in short supply, BofA pointed out.[6]

Our approach to impact investing: trust but verify
Investors, it seems, have been quick to adapt to the trend towards sustainability, increasingly swapping "polluting" stocks for shares of companies more aligned with environmental, social and governance standards. We for our part have a long track record of building portfolios around "clean technology" companies. Many of them provide products and services to make the world a greener place, which should also benefit their shares, in our opinion.

As active asset managers, and more specifically, impact investors, we are in the business of picking our portfolio positions carefully, looking at each possible candidate for a "clean tech" portfolio. This differs fundamentally from a passive asset manager's approach of tracking a set of companies in a "sustainable" index. The names we choose meet specific targets, for instance contributing to at least one of our impact objectives ("impact pillars") and one or more of the United Nations' Sustainable Development Goals (SDGs). We also track the impact of our holdings using specific key performance indicators to illustrate the favorable impact. These measures include, for example, tons of carbon emissions potentially saved, or the amount of cargo transported by rail rather than by truck. All in all, our approach to portfolio construction could qualify as "trust but verify", a time-tested method.[7]

[4] "The heat is on, Italy plans to turn down air conditioning to save energy", Reuters, April 20, 2022
[5] "Habeck: Deutschland könnte diesen Winter Gasboykott überstehen», Deutschlandfunk, May 12, 2022
[6] "Scarcity Primer", BofA Global Research, February 23, 2022, citing data from the International Energy Agency
[7] "Trust but verify", a Russian saying used by Vladimir Lenin, according to some accounts. It was popularized in America by US President Ronald Reagan during the signing ceremony of the Intermediate-Range Nuclear Forces Treaty with then Soviet leader Mikhail Gorbachev in December 1987.

We focus on good-quality corporate bonds as recession fears rise

—
Sandrine Perret
Senior Economist,
Fixed Income Strategist,
Vontobel

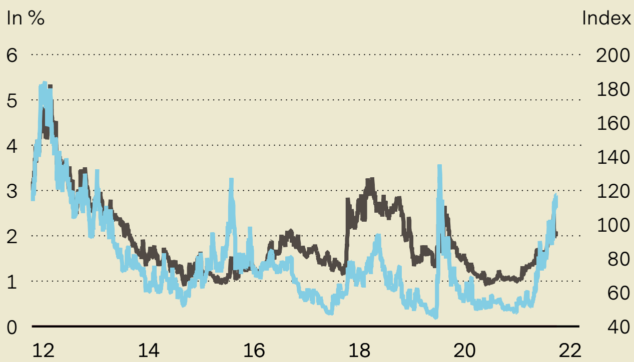
Central banks continue their fight against inflation. Slowing economic activity and yield levels at record highs will be a tricky combination for corporate bonds in the second half. We reduce our exposure to the high-yield corporate bond segment and put more focus on high-quality debt.

As we enter the summer months, it's still a tough time for the weakest parts of the bond market. In Europe, bond spreads of so-called peripheral (i.e. mostly southern European) issues versus a German government bond benchmark widened sharply around the June meeting of the European Central Bank when the ECB confirmed that rate hikes would start in July. Fears of renewed fragmentation risks in the European periphery sent Italian yields to above 4%, a new cyclical high. At the same time, the gap between Italian ten-year yields and their safer German counterpart rose to the highest level since the start of the pandemic (see chart 1). Pressure then eased as the ECB called an emergency meeting and promised to set up a fresh backstop tool in order to cap spreads. But only the details and conditionality of this new tool, not yet known, will determine whether it could be as effective as the former ECB President Mario Draghi's famous "whatever it takes" statement that calmed the markets in 2012.

High volatility prevails in the fixed income market
The uncertainty in the bond space is not limited to Europe. A measure of bond volatility, the MOVE index, rose again in June, highlighting that the stress level exceeds that of equities. In this environment, we remain neutral on fixed income overall with a preference for government bonds.

Signs are getting clearer that economic growth is slowing, albeit from a high level. We believe that the second half of 2022 will prove much more challenging with recession risks continually rising. In the short term, central banks have no other choice but to continue to tighten monetary policy because they must ensure price stability. With that in mind, we have reduced our exposure to low-quality corporate bonds, moving our liquidity to highest-quality ones, i.e. investment-grade bonds. It's worth noting that despite the ongoing fall in the prices of corporate paper – which leads to higher yields and consequently, a wider gap to government bonds – there is more room for further spread widening. Likewise, we believe that default rates will increase. Against the backdrop of a slowing economy, this suggests an outperformance of the highest-rated corporate debt segment, as has been the case most of the times the US new orders index fell below the 50 mark (see chart 2).

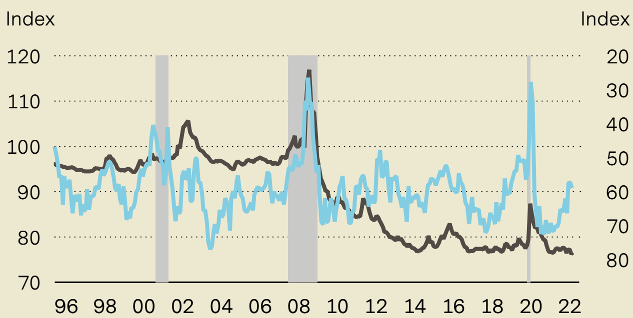
Chart 1: Italian bond spreads have increased together with the cost of protecting against default



— 10-year Italian vs German government bond spreads
— Credit default measure Itraxx for Europe (right-hand scale)

Source: Refinitiv Datastream, Itraxx, Vontobel

Chart 2: High-yield bonds tend to underperform higher-quality paper in times of slowing growth



— Relative performance of US AAA vs BBB-rated corporate bonds
— US ISM manufacturing new orders (right-hand scale, inverted)
■ Recession

Source: ICE BofA, Institute for Supply Management, Vontobel

Thinking about re-engaging? Watch the following signals

—
Stefan Eppenberger
Equity & Commodity Strategist,
Vontobel

Shares are down this year but not out, so it is hoped. After cashing out, many investors will now be looking for an opportunity to re-enter a significantly cheaper market. We have put together a ten-point checklist they may find useful.

Equity investors that voted with their feet are likely to realize at some stage they have ventured too far. Our list of ten signals could help them to time their return to the fold. The first four points are technical in nature. For instance, a mark of above 40 in the VIX "fear" index or very high put-call ratios (investors protecting themselves against losses by buying "put" options enabling them to sell securities at a predetermined price) indicate a so-called market capitulation. At that point, markets riled by wild swings and steeply falling prices may be about to calm down. We also think it will be worth buying the dip if equities retreat another 10% from current levels, bringing the year-to-date loss to 35%. Readings below this mark have mostly been seen only in the event of a systemic crisis, which we don't expect to happen. Price-to-earnings ratios of below 12.5 should also offer entry opportunities, but we're currently far from that at above 15. Other possible turning points for equity markets include yields on corporate bonds so high that they reflect recession territory (we're not there yet), and downgrades of at least 10% in analysts' earnings expectations (very few downgrades so far).

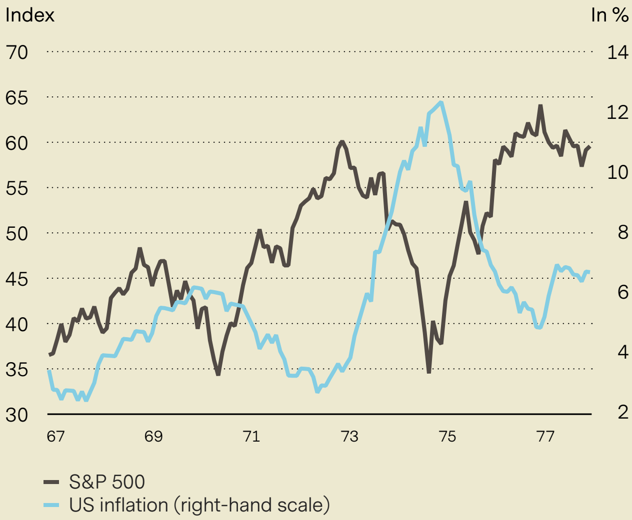
The second category of signals focuses on inflation and how central banks react to it, among the main reasons for this year's equity market downturn. In this respect, we are at a similar stage like in the 1970s when lax central banks first fanned inflation and later had to adopt a brutal tightening policy that caused a recession. At that time, the inverse correlation of stock prices with inflation was striking (see chart 1), similar to today's situation, and the moves by the US Federal Reserve had a major impact on equity markets (see chart 2). It follows that equities should become much more attractive when inflation peaks and the US central bank hints at a looser monetary policy.

The third category comprises economic indicators, which are still solid but accident-prone. Historically, a recovery in equities has coincided with a fall in indicators such as purchasing managers' indices below 45 or a rise in the unemployment rate by at least 1% in the next few months.

Wait for some lights to turn green

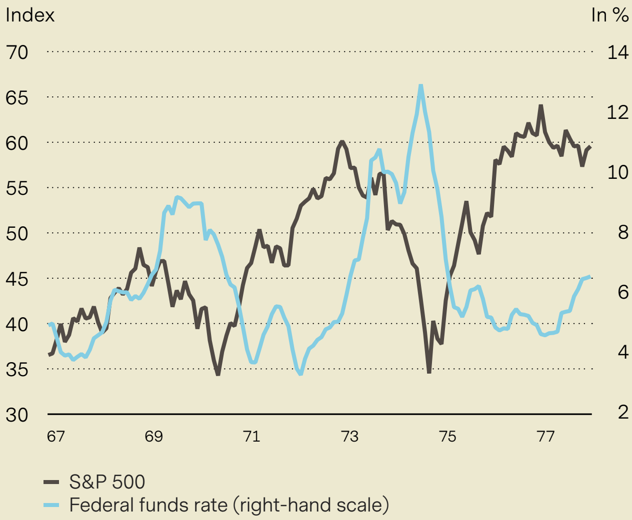
So far, none of our ten metrics has generated a buy signal, but things could change fast. For now, we remain patient and neutral, waiting for at least a few lights to turn green.

Chart 1: In the 1970s, equities recovered immediately after inflation had reached a peak



Source: Global Financial Data, Refinitiv Datastream, Vontobel

Chart 2: The US Federal Reserve's easing and tightening cycles showed the way for stocks in the 1970s



Source: Global Financial Data, Refinitiv Datastream, Vontobel

Remain true to gold? A question of perspective

—
Stefan Eppenberger
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As the ultimate gold fan, the villain Goldfinger in the eponymous James Bond movie wouldn't be too pleased this year. The price per troy ounce has hardly moved despite a temporary surge after the Russian invasion of Ukraine. We remain true to the yellow metal, not least because we expect a lower US dollar.

Gold should be a natural hedge against inflation and crises, but has disappointed on both counts. It is still trading at just over 1,800 US dollars, nearly unchanged since the beginning of the year. Many long-time gold investors, us included, would have welcomed another counterweight to the miserable returns on equities and bonds, besides commodities. Alas, it was not to be.

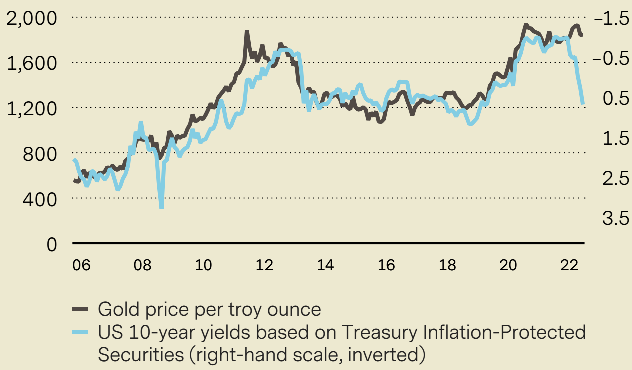
But we need to put this supposedly poor showing into perspective. Like most other asset classes, gold has benefited from years of loose monetary policies. Whilst the central banks' money glut led to inflows into gold, it also lowered real yields (yields minus the inflation rate). Currently, the US Federal Reserve's switching to inflation-fighting mode is moving these yields higher again. And amid a growing appetite for interest-bearing securities, investors are facing a more than 1 % rise in opportunity costs of holding gold so far this year. Against this backdrop, the stable gold price is remarkable (see chart 1).

The current broad upward move in base rates should be gold-supportive. A tighter monetary policy typically gives rise to growth fears, which in turn help the yellow metal. Historically, gold performs strongly during rate-hiking cycles, particularly when central banks turn restrictive fast.

A weaker dollar could boost the precious metal
Gold's lackluster performance is to a large extent a function of dollar strength. When key rates rise, the USD tends to depreciate, but investors are currently seeking refuge in the currency due to high geopolitical uncertainty. Moreover, the central banks in Europe and especially Japan are clearly less enthusiastic than the US Fed about tightening monetary screws, which lifts the Greenback. This reduces demand for gold from non-dollar areas such as Asia. Retail demand in China, which accounts for about one-third of the global total, remains suppressed given that a weakening Chinese yuan makes purchases of dollar-denominated gold more expensive (see chart 2).

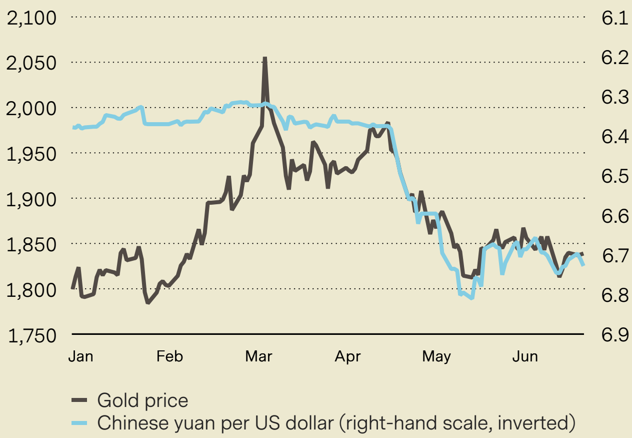
Gold's glitter is in the eye of the beholder
The attraction of gold is in the eye of the beholder. Measured in yen or euros, the gold price is trading at all-time highs. Moreover, once the US central bank lets the reins slip again amid rising recession fears, the US dollar should give up ground and gold in US dollar terms climb to new highs. We stick with our gold overweight.

Chart 1: The yellow metal holds its own despite rising real yields



Source: Refinitiv Datastream, Vontobel

Chart 2: Chinese buyers face higher costs of gold buys due to a weaker domestic currency



Source: Refinitiv Datastream, Vontobel

Swiss franc bolstered as central bank flags independence

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The Swiss franc ticked higher after the country's monetary authority reasserted its independence from the European Central Bank (ECB) in hiking rates by 50 basis points. While the Swiss National Bank's (SNB) move is particularly relevant for the EUR/CHF exchange rate, it supports our view that the US dollar is likely to depreciate after peaking during the summer months.

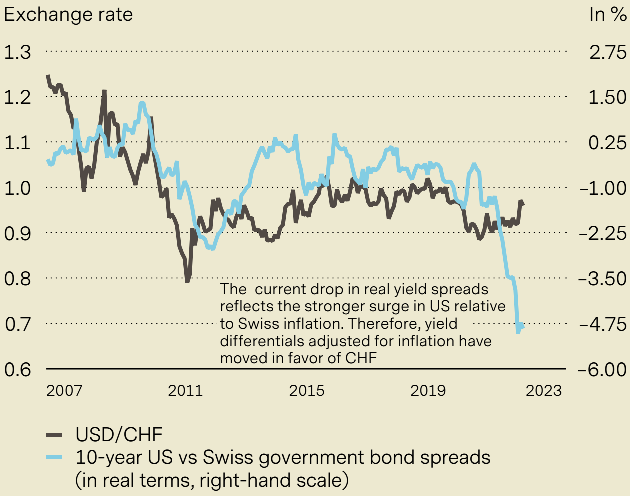
A peak in US inflation will probably coincide with the US Federal Reserve's "peak hawkishness", i.e. maximum inflation-fighting commitment. Once the Fed adopts a softer language, a turning point may be reached not only in US monetary policy, but also for global yields, the US dollar, and many currency crosses. Just when this might happen is anybody's guess, but signs have emerged that inflation may be slowly retreating. For example, the US "core" consumer price index (without volatile elements, e.g. energy) has been moving lower since March, a trend also seen in prices for semiconductors and container shipments, both of which have been sources of supply-chain bottlenecks.

The Swiss franc will probably be a prominent beneficiary. It has already gained ground recently given a leisurely upward stroll in Switzerland's inflation rate compared to the surge in the US and the euro area. We see the fair value of the Swiss franc versus the US dollar in terms of purchasing power parity at around 0.80 compared with a current exchange rate of 0.96 (see chart 1). Switzerland's sizable current account surplus of almost 10% of GDP and the SNB's leaving the ECB behind on the rate-hiking trail suggest the USD will lose ground, particularly if the US Fed's inflation fighting resolve wears off.

Euro seen benefiting little from dollar weakening
While the euro would also benefit from a top in the US dollar, we believe that economic headwinds in Europe will prevent the area's currency from making much headway versus the dollar. For instance, Russia might reduce or even stop gas deliveries to Europe, and the continent may face political trouble after French President Emmanuel Macron lost a majority in French parliament. Moreover, the rise in global yields brought back investors' concerns regarding the ability of countries to honor their debt (see chart 2). These factors make it hard for the ECB to "normalize" its monetary policy, i.e. raise interest rates, and they limit the euro's potential. We reckon the Swiss franc may break sustainably below parity versus the euro on the foreign exchange market over the next few months.

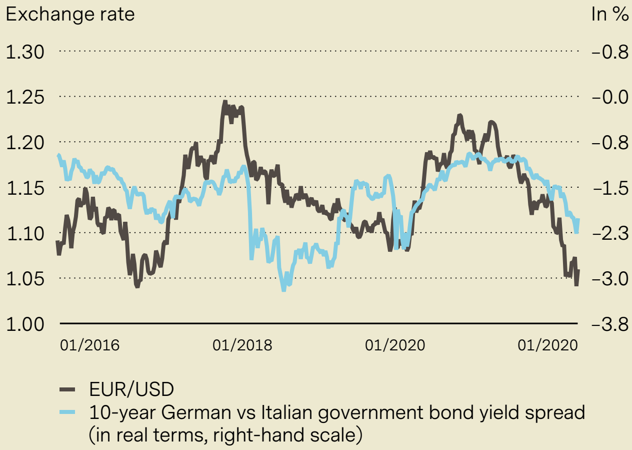
A lower dollar is also likely to boost emerging-market currencies. At the same time, they are likely to benefit from expectations of a stabilization in Chinese economic growth later this year.

Chart 1: Fall in spreads of bond yields suggests Swiss franc's rise versus the US dollar



Source: Refinitiv Datastream, Vontobel

Chart 2: Doubts about European debtors and rising "periphery" yields reflect limited euro potential



Source: Refinitiv Datastream, Vontobel

Economy and financial markets 2020 – 2023

The following list shows the actual values, exchange rates and prices from 2020 to 2021 and our forecasts for 2022 and 2023 for gross domestic product (GDP), inflation / inflationary expectations, key central bank interest rates, ten-year government bonds, exchange rates and commodities.

GDP (IN %)	2020	2021	CURRENT[1]	FORECAST 2022	FORECAST 2023
Euro zone	–6.5	5.3	5.4	2.8	1.7
US	–3.4	5.7	3.5	2.4	1.1
Japan	–4.6	1.7	0.7	2.0	1.7
United Kingdom	–9.3	7.4	8.7	3.4	1.6
Switzerland	–2.5	3.7	4.5	2.5	1.4
China	2.2	8.1	4.8	4.3	4.8
INFLATION (IN %)					
Euro zone	0.3	2.6	8.1	7.3	3.2
US	1.2	4.7	8.5	7.6	3.7
Japan	0.0	–0.3	2.5	2.0	1.0
United Kingdom	0.9	2.6	9.0	7.9	5.0
Switzerland	–0.7	0.6	2.9	2.4	1.5
China	2.5	0.9	2.1	2.2	2.1

KEY INTEREST RATES (IN %)	2020	2021	CURRENT	FORECAST 3 MONTHS	FORECAST 12 MONTHS
EUR	–0.50	–0.50	–0.50	0.25	1.00
USD	1.75	0.25	1.75	3.00	3.50
JPY	–0.10	–0.10	–0.10	–0.10	–0.10
GBP	0.75	0.25	1.25	1.75	2.00
CHF	–0.69	–0.76	–0.25	0.00	0.75
CNY	4.35	4.35	4.35	4.35	4.35
10-YEAR GOVERNMENT-BOND YIELD (IN %)					
EUR (Germany)	–0.2	–0.6	1.7	1.5	1.0
USD	1.9	0.9	3.3	3.2	2.5
JPY	0.0	0.0	0.3	0.3	0.3
GBP	0.8	0.2	2.5	2.4	2.0
CHF	–0.5	–0.5	1.4	1.4	1.2
EXCHANGE RATES					
CHF per EUR	1.09	1.08	1.02	1.03	0.98
CHF per USD	0.97	0.88	0.97	0.99	0.88
CHF per 100 JPY	0.89	0.86	0.73	0.76	0.70
CHF per GBP	1.28	1.21	1.19	1.20	1.17
CHF per AUD	0.68	0.68	0.67	0.71	0.66
USD per EUR	1.12	1.22	1.05	1.04	1.12
JPY per USD	109	103	133	130	125
USD per AUD	0.70	0.77	0.70	0.72	0.71
CNY per USD	6.95	6.51	6.86	6.80	6.70
COMMODITIES					
Crude oil (Brent, USD/barrel)	66	52	120	100	100
Gold (USD/troy ounce)	1,521	1,898	1,836	2,000	2,200
Copper (USD/metric ton)	6,149	7,749	9,080	8,000	10,000

[1] Last officially available quarterly data year-over-year
na: not yet available
Source: Thomson Reuters Datastream, Vontobel; closing prices for all data: June 16, 2022, forecasts as of June 23, 2022

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