Vontobel

Investors' Outlook

2023—
Preparing for pivots

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Content

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2023—Preparing for pivots

Dear readers,

We've finally left annus horribilis 2022 behind us—and while there are still some gloomy pockets in the economy, some market areas started the new year off on a strong note amid positive developments that give reason for hope.

Europe got lucky energy-consumption-wise in that it experienced a warmer than normal festive season, providing respite from concerns over a worsening energy crunch in the region. The mild temperatures provided the continent with a cushion of relief, even though mid-January saw many parts of Europe hit by a cold snap. Europe has now built up enough gas in storage to cope this year, even with Russian gas completely shut out of the supply chain. Of course, the unseasonably warm weather is a stark reminder that the world is grappling with climate change—a gravely serious challenge that brings energy concerns in and of itself.

Perhaps one of the biggest—and most important—surprises of late has come out of China, where the government has finally eased nearly three years of strict Covid-19 containment measures. The government also moved to support its ailing housing market and eased its crackdown on big Chinese technology companies. The reopening, coupled with fresh stimulus, will help China emerge strongly from a recession. This will also provide a much-needed boost to the global economy, where the US and Europe are seeing economic momentum continue to decline.

Communication levels are also thawing between China and the US. January saw US Treasury Secretary Janet Yellen and Chinese Vice Premier Liu He agree to strengthen communication on macroeconomic and financial issues while attending the World Economic Forum in Switzerland. This alignment feeds hope for improvement in the bilateral relationship between the world's two largest economies, especially given the climate of competition that has characterized their dynamic to date, and amid current tensions related to technology.

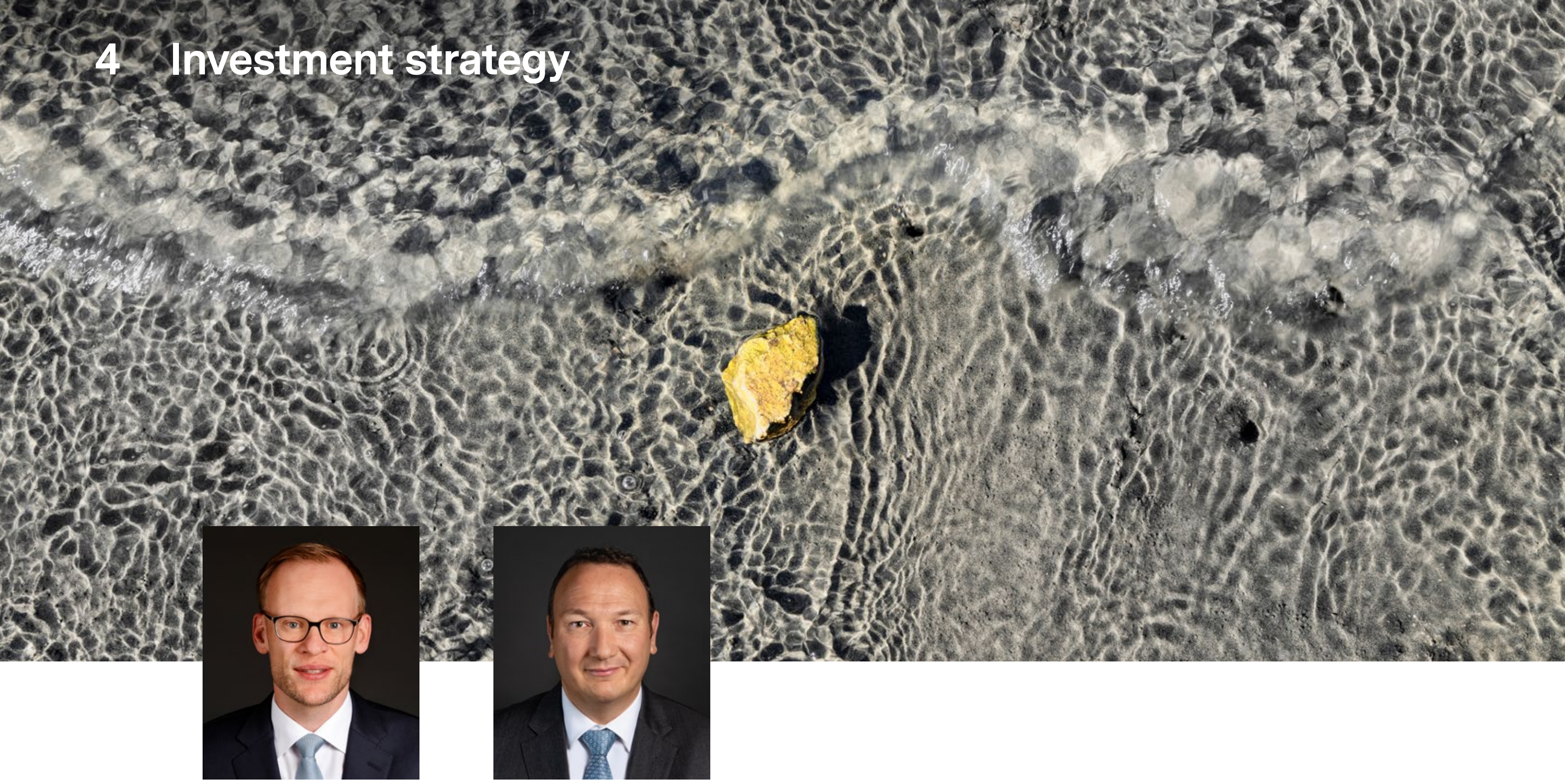
—
Dan Scott
Head of Vontobel Multi Asset,
Vontobel

Finally, inflation levels have come down quickly, most notably in the US. What do the decreases, hot on the heels of a year in which the investment community was plagued by recession fears, mean for the months ahead? While it's true that things could get worse for the economy before they get better, especially as central banks may hang on to their restrictive monetary policies through the first six months of 2023, neither last year's worries about a deep recession nor fears of lingering high inflation levels currently look likely to eventuate this year. Instead, our base case of a short and shallow recession looks increasingly plausible. Lower inflation and more accommodative central banks are likely to lead to more economic growth in the second half of the year.

In this Outlook, you'll find our take on the most recent developments in the markets and the economy, including why we see opportunities appearing in emerging-market equities, what to expect in the copper market and what's next for the US dollar. I recommend you turn to page 8 and read Vontobel Chief Executive Officer Zeno Staub's recent letter to investors. And starting on page 4, our Chief Investment Strategist Frank Häusler details our asset allocation.

As an active investor, I'm looking forward to sharing my thoughts with you and making the most of the opportunities that present themselves over the course of this year.

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



—
Frank Häusler
Chief Investment Strategist,
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Some pivots in equities amid positive developments

We maintain our positive views on equities and gold. Within equities, we upgrade emerging-market stocks and trim their Swiss peers. We continue to stay neutral on bonds and commodities and keep our underweight position in cash. Here's why.

2022 saw an unprecedented amount of monetary policy tightening. As it typically takes some time before the effects of central bankers' actions start to be felt in the real economy, many economic indicators still paint a gloomy picture. Therefore, a recession is a very real probability in many parts of the world.

On a positive note, China's decision to ease its strict Covid-19 restrictions boosts not only its own economic prospects but those of the global economy as well. Other bright spots include lower inflation prints, most notably in the US, driven by sharp declines in the energy and goods components.

Central bankers are taking note of these shifts. We expect the US Federal Reserve to raise interest rates to five percent and then hold them at that level for some time; how long depends on the US labor market. Though it's still too strong for the Fed's liking, the first cracks have started to appear: companies have lowered their hiring intentions and layoffs have begun, which may pave the way for rate cuts later this year.

Equity markets started the year off strong due to several factors, ranging from positive cues coming out of China to the easing of Europe's energy crisis, as well as slowing inflation and hopes for less restrictive monetary policy going forward. Given the current macroeconomic backdrop, we turn slightly more cyclical and upgrade emerging-market equities to neutral from underweight while maintaining our overall weight in stocks. Emerging-market stocks are poised to benefit from China's reopening and its latest measures to support its ailing property market, as well as from the weakening US dollar. In turn, we trim the more defensive and expensive Swiss equities to neutral from overweight.

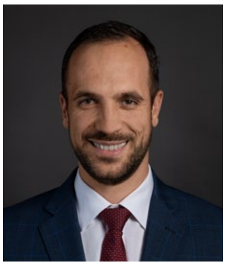
Bond markets have started to turn around somewhat as rates edged lower and spreads tightened. This momentum continued into 2023. We maintain a neutral view on bonds and have held our overall allocation, favoring government and emerging-market bonds with an overweight stance. We are neutral on investment-grade bonds and negative on the high-yield segment. We believe default rates will rise, and credit spreads do not fully reflect the looming recession.

We still favor gold with an overweight view, as we believe many of the headwinds that plagued it in 2022—a hawkish Fed, a strong US dollar, and rising real yields, to name a few—should turn into tailwinds in 2023. We maintain a neutral view on commodities. Details of our positioning can be found on the overview on page 5 or the asset class-focused items on pages 12 to 15.

	UNDERWEIGHT		NEUTRAL	OVERWEIGHT		
	significantly	slightly		slightly	significantly	
1 Liquidity		→				As we consider the current environment a good entry opportunity for long-term investors, we maintain our decision to cautiously overweight equities. We therefore keep our slightly underweight stance on cash.
2 Bonds			→			Just like equity markets, bond markets are also looking back at a gruesome year. The combination of surging inflation and restrictive monetary policy was a painful pill to swallow. As rates edged lower and spreads tightened towards the end of the year, things began to turn somewhat. The positive momentum continued in 2023, with all major segments starting into the new year with a positive performance. On a 12-month horizon, we expect to see lower bond yields. This is due to a weaker US economy and peaking inflation, which has historically been followed by lower yields. In our opinion, it is still too early to move to an overweight stance, and we therefore reiterate all of our most recently expressed convictions (overweight for government bonds and emerging-market bonds in hard currency, neutral for investment-grade credit, and underweight for high-yield bonds).
3 Equities				→		We maintain our cautious overweight in equities as the overall backdrop has not changed materially since the last Investment Committee in November. Equity markets started the year with a positive performance across all major indices. This was due to several factors, ranging from positive news from China to the relaxation of the European energy crisis, slowing inflation and hopes for a less restrictive monetary policy going forward. Given the current macroeconomic backdrop, we deem it sensible to adjust our portfolio a bit more cyclical and upgrade emerging-market equities to neutral from underweight. Emerging-markets are not only poised to benefit from the reopening of the Chinese economy and the Chinese government's latest measures to support the country's ailing property market, but also from the weakening US dollar. In a second step, we trim Swiss equities (which are more defensive and expensive) to neutral from overweight. All other regional preferences remain unchanged as we continue to favor US equities and stay neutral for their European and Japanese peers. While we expect economic growth to deteriorate further in the coming months, we think that the combination of falling inflation and the likely end of the Fed's rate-hiking cycle around mid-year 2023 could provide enough support to equities.
4 Gold				→		We keep our overweight in gold. The yellow metal struggled to work its way up last year, as the Fed's hawkish stance lowered inflation expectations, pushed up real yields, and boosted the US dollar. We believe that gold is set to benefit from a less restrictive Fed going forward. In addition, we also appreciate gold as a hedge against any escalating geopolitical risks and sudden bouts of inflation.
5 Commodities			→			We continue to feel comfortable with a neutral view on commodities. Their attractive longer-term prospects following China's reopening and real estate sector stimulus are somewhat offset by short-term headwinds of rising recession fears. Against this backdrop, we deem it sensible to maintain an overall neutral view on the asset class.
6 Alternative strategies			→			We maintain our neutral view on alternative investments overall and reiterate all sub-asset class views, i.e., a modest underweight in hedge funds and a neutral view on real estate.

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

“Quo vadis”, Chinese real estate market?



—
Michaela Huber
Cross-Asset Strategist,
Vontobel

—
Stefan Eppenberger
Head Multi Asset Strategy,
Vontobel

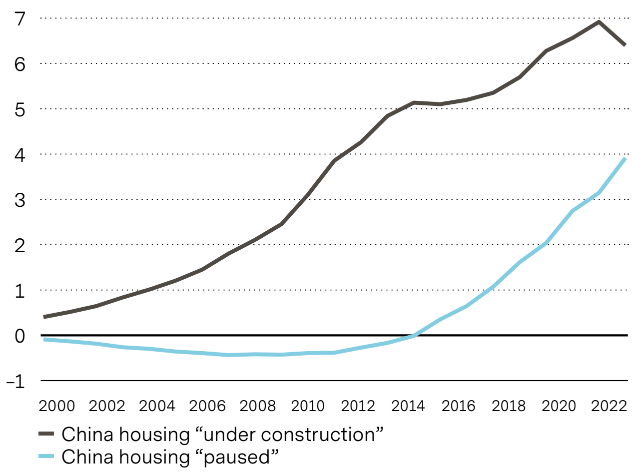
China’s economic reopening has dominated the headlines lately. As a result, the woes of the Chinese property sector have taken a backseat. We take a look at the property crisis amid the reopening.

China’s real estate market: from former poster child to problem child
A little over a year ago, China Evergrande gained global notoriety. Shortly after China’s second-largest real estate developer admitted that it would be under “enormous pressure” and that there was a risk of default, media outlets reported about unfinished projects, missed coupon payments, and angry investors demanding their money back in the company’s lobby. Given the size and importance of China’s real estate sector—which is estimated to account for up to 30 percent of China’s GDP and often dubbed “the world’s largest asset class”—the question even arose whether this was “China’s Lehman Brothers moment”.

Developers in focus: when a leveraged business model suddenly faces regulatory scrutiny
The payment difficulties for Evergrande and other developers did not come out of the blue. For decades, the business model of Chinese real estate developers had been to raise significant amounts of debt capital to build more and more new properties. In the case of Evergrande, for example, liabilities consistently amounted to more than 80 percent of total assets. Then came the introduction of the “three red lines” policy in August 2020, and developers suddenly had to comply with strict financial requirements if they wanted to take out loans. As a result, many underfunded developers were unable to complete their already sold projects on time or at all, which in turn discouraged further investment (see chart 1).

How has China responded?
While China’s regulators continue to stress that they want to cool down the overheated real estate market, a rethink seems to have taken place late last year. In November, for example, a 16-point plan was unveiled that, among other things, gave banks more leeway in lending

Chart 1: Vicious circle—underfunded developers cannot finish projects (that were presold)
In billion square meters (cumulative)



Source: Refinitiv Datastream, Vontobel
Note: Data are based on official Chinese statistics. Consequently, the starting level of “paused” housing is unknown. This results in a net negative number in 2000 – 2014.

to developers. In addition, both the down payment amount and the mortgage interest rates for homeowners were lowered to promote real estate sales. A little later, the People's Bank of China followed suit: it rounded up the heads of the major Chinese banks, instructed them to engage in more active lending, and promised the banks that it would provide around USD 28 billion by March 2023 for the interest-free refinancing of such loans. The recent shift away from China's strict "zero-Covid" policy should be another positive stimulus, leading to more real estate transactions and more revenue for developers. All this should limit the risk of additional defaults and break the negative feedback loop between financial stress for developers and declining sales of properties—at least for now.

So, what's next?
In 2023, policymakers are likely to continue to support the real estate market with regulatory easing and expansionary monetary policy. At the time of writing, there is growing speculation that policymakers plan to loosen restrictions on developer borrowing rules stipulated under the "three red lines".

There is, however, a big caveat, namely the structural challenges that China's real estate market is facing. One such challenge is the high level of speculation in the market. In a country where the home ownership rate is an impressive 96 percent (compared with 65 percent in the US), homes are no longer bought just to live in. In 2017, second or even third properties accounted for more than half of domestic Chinese sales. As a result, the vacancy rate has skyrocketed—it is estimated that around one-fifth of Chinese apartments were empty in 2021.

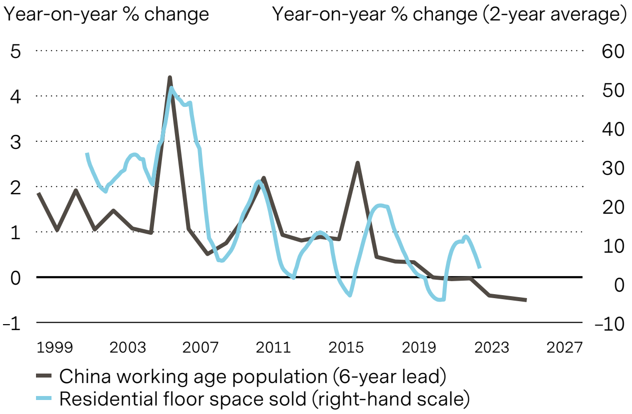
At the same time, home ownership is becoming increasingly unaffordable. So-called "first-tier" cities in China are among the most expensive in the world. The ratio of median house prices to income rose to over 25 in Beijing at the end of 2021, compared with around 20 in Hong Kong and just seven in the US.

This is compounded by unfavorable demographic trends. According to the United Nations, China's working-age population will decline rapidly from the 2030s and shrink by almost two-thirds by the end of the century. This is expected to reduce demand for housing and demand to purchase property (see chart 2).

As long as policymakers do not allow for a comprehensive restructuring, there is a risk that the structural problems will worsen with each housing cycle. For a sustainable, long-term solution, significant debt reduction, higher defaults, a pronounced recession, and substantial government support seem inevitable.

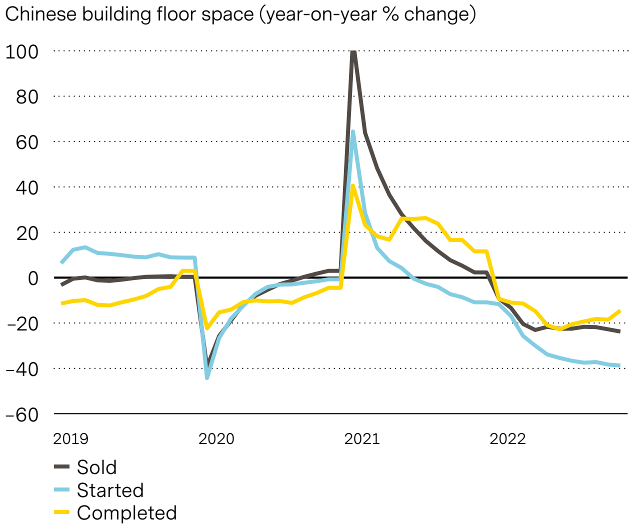
Signs investors should watch out for
There is a set of indicators that would suggest a turnaround or at least an easing of the situation. One such indicator would certainly be a recovery in construction activity. Here, the latest political measures would have to boost real estate development (see chart 3). Another important indicator comes in the form of house prices, which have started to fall across the country in 2022. Finally, a recovery in real estate sales is also needed. Chinese real estate transactions were weak by historical standards throughout last year and weakened further, especially at the end of the year.

Chart 2: A shrinking working age population lowers demand for housing



Source: Refinitiv Datastream, Vontobel

Chart 3: All eyes on housing activity



Source: Refinitiv Datastream, Vontobel

A closer look at the implications of today’s challenges

—
Zeno Staub
Chief Executive Officer,
Vontobel

Looking ahead, we must face the fact that many of today’s challenges cannot be eliminated rapidly, and that the cost of resolving them will be significant. This will put diverse societies to the test.

The CEO letter was first published in December 2022.

The illusion that we don’t have to pay a price for money, security, or energy has now been shattered. Further, the hubris-induced monetary and fiscal bubbles that had formed have now burst: major central banks in developed countries have embarked on the painful path of interest rate hikes and gradual quantitative tightening. Widespread fiscal carelessness reached its limits with Liz Truss’s failed mini budget—if not beforehand. We have to recognize that there are no more monetary or fiscal measures that can be used to spread the costs of upcoming challenges across all members of society or to defer those costs to the future. In economists’ speak: This is not a V-shaped but rather a U-shaped crisis.

The energy crisis triggered by the war in Ukraine and the resulting effects on energy pricing will have a major impact on the way we address the challenge of climate change and the speed at which much-needed action can be taken. In addition, the world seems to be on an unstoppable course towards a multi-polar era. The strategic competition between the US and China seems to be evolving at lightning speed from trade war to tech war to cold war. In view of the latest round of US sanctions in the high-tech sector and the announcements regarding the leadership of the Communist Party of China made at its 20th National Congress, there is no sign of these tensions diminishing. At the very least, these developments will lead to the restructuring of global supply chains and possibly to increased regionalization and greater resilience. In the short term, the energy crisis and the overhaul of energy infrastructure on the one hand, and the restructuring of supply chains on the other, will drive up consumer prices in the West and dampen global economic output. And this is all happening as China, as a major global supplier, emerges from restrictions due to its Covid policy, which it has been easing.

All of this has implications for consumers in major western countries. Life will become more uncertain, and the cost of living will increase. In Europe, the Consumer Confidence Indicator has fallen to its lowest level in more than 25 years. In the US, where the direct impacts of the war in Ukraine are much less visible, the Consumer Confidence Index has fallen significantly from its all-time high a year ago. This has consequences for the same set of people if you ask them in their capacity as eligible voters, as demonstrated by the results of voting in many western democracies where the political margins have increased. These are developments that are being driven by voters in today’s middle classes who are, themselves, motivated by their fear about a loss of status and prosperity.

This uncertainty is also reflected by the Edelman Trust Barometer, which has been widely cited for years: The majority of the respondents around the globe expressed the view that capitalism in its current form causes more harm than good in the world. And 33 percent of the respondents in 21 democracies are convinced that centrally planned economies work better than free market economies.

In recent years, many of these societies have also seen massive demographic changes: They are no longer homogenous in terms of the ethnicity, language, or religion of their people, and they therefore have greater difficulty in achieving consensus in their democratic processes. And they often have an ageing population and have to deal with challenges related to healthcare costs and the distribution of wealth. These societies should now tackle those problems which—as we know from political economics—are notoriously difficult for diverse societies to solve. We are talking about solutions that will create a small number of known and well-organized losers—for the benefit of a large number of fragmented, politically disorganized winners in the future. How is that supposed to work?

In his most recent book entitled “The Great Experiment—How to make diverse democracies work”, Yascha Mounk, Professor of International Affairs at Johns Hopkins University, provides some excellent pointers, which I am freely summarizing here. For diverse societies to be able to reach a stable political consensus, their institutions and rules need to fulfill a series of conditions:

- Increasing per capita wealth, which leads to a dignified standard of living for people across the entire income scale;
- meritocratic equality of opportunity for all, underpinned by social solidarity and redistribution, but without a targeted, patronizing minorities policy that all too often erodes the social consensus for solidarity;
- effective and stable institutions that are trusted by citizens and provide legal certainty and equal rights; and
- mutual respect, e.g., between the losers and winners in democratic processes, as well as towards the institutions that oversaw the socio-political debate.

It is up to each individual to decide where different societies stand in terms of these success factors. However, the article “Poor societies with some very rich people” published in the Financial Times offers food for thought on this topic, as does the work of the US think tank Fund for Peace, with its Fragile States Index. The fact that Switzerland scores highly in many of these rankings is confirmation of the quality of its institutions and rules that have developed over centuries. When Switzerland was created, it was a groundbreaking nation in terms of the structures: A parliamentary system with two chambers, with massive support for the weaker regions at that time, as well as direct democracy, federal structures, and subsidies to support the building of the state from the bottom up. A modern social welfare system was introduced at the start of the 20th century—just in time to render obsolete any extension of the Swiss general strike.

Enormous challenges lie ahead for diverse societies that wish to remain democratic. The solutions needed to address many imminent problems involve taking steps that run contrary to the individual, short-term maximization of benefits. It will be essential to conduct an intensive, open and honest dialogue in this context. I will support these efforts with conviction. As we look ahead, I wish you and your families, partners, and friends a happy, healthy and successful 2023.

Is the end of the Fed hiking cycle in sight?

—
Christopher Koslowski
Senior Fixed Income & FX Strategist,
Vontobel

The bond-bearish dynamic of 2022, in which central banks became increasingly hawkish as inflation accelerated, has ended. Shifting projections of peak policy rates and the timing of future rate cuts will be the primary drivers of bond yields in 2023.

Our overall outlook for fixed income remains neutral. We are overweight in government bonds as well as emerging-market bonds in hard currency, neutral in investment-grade corporate bonds, and underweight in high-yield bonds.

The federal funds rate is approaching a level considered restrictive
Economic theory suggests that positive real short-term interest rates are needed for restrictive monetary policy to slow the economy and, by extension, inflation.

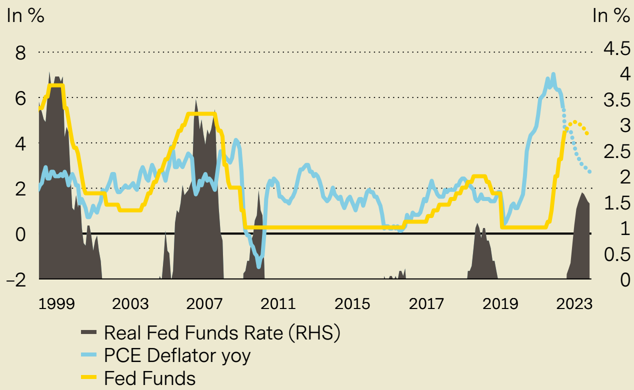
The Fed has never stopped hiking rates until the federal funds rate was above the Fed's preferred measure of inflation. If consensus estimates for PCE (Personal Consumption Expenditures) are broadly achieved and the Fed raises rates as expected (see dotted lines in chart 1), the real federal funds rate will turn positive in February 2023 and approach two percent by the end of the year. We expect the Fed to scale back rate increases. The market is pricing in two 25-basis-point rate hikes at the following meetings, bringing the policy rate to five percent. The market is anticipating rate cuts by the end of 2023, but Fed officials are indicating that they plan to hold rates high for "longer"—until they are confident that inflation is credibly heading to the two percent target. That discrepancy between what the market is pricing in and what the Fed is signaling is likely the key to the direction of yields for much of the year. We lean toward the market view that the Fed will likely be cutting rates.

By mid-year, the aggressive rate hikes should total about 475 basis points, making it the fastest hiking cycle in decades. This should result in weaker economic growth and continued falling inflation, pulling yields lower and steepening the yield curve.

Going forward, the main driver of bond yields will be shifting assessments of peak policy rates and the timing of future rate cuts. Historically, this stage of the economic cycle we are in now, where interest rates are still rising but inflation shows signs of stabilizing or even declining, favored developed country sovereign debt in the first instance.

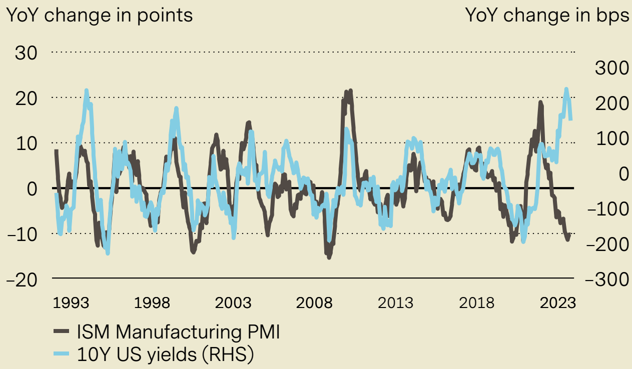
With respect to credit markets, we maintain a defensive stance towards overall credit allocation versus government bonds, while we view high-yield spreads as less appealing. However, valuations in emerging-market bonds are attractive, and breakeven spreads offer some protection.

Chart 1: Federal funds rate is approaching a level considered restrictive



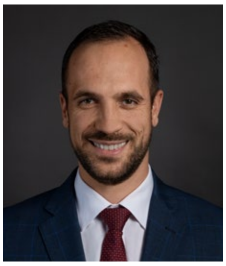
Source: Bloomberg, Vontobel

Chart 2: The last time yields and PMIs diverged to such an extent, yields subsequently declined (1994)



Source: Refinitiv Datastream, Vontobel

Emerging-market stocks: The worst is behind us



—
Stefan Eppenberger
Head Multi Asset Strategy,
Vontobel

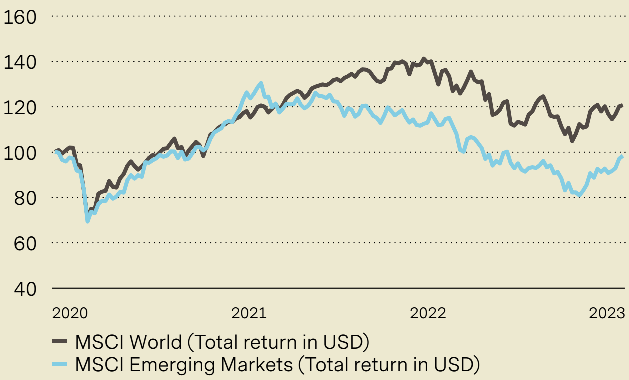
Weaker economic growth in China and a strong US dollar have hurt emerging-market stocks over the past two years. The recent reversal of China's "zero-Covid" policy and the expected upcoming end of the US rate hike cycle should stop these headwinds. We are increasing our allocation to neutral.

The long-term positive story about emerging-market equities is clear. Higher population and wealth growth are hitting underinvested financial markets. Those with a long puff should benefit accordingly from stronger corporate earnings and higher equity valuations. However, recent years have shown that it is not that simple.

Economic growth has also been weakened in emerging markets, especially in China, by Covid-19 and rigid lockdown policies. But even more critical to the underperformance of emerging stocks is the governance aspect. Not only have shareholders often been diluted by capital increases, but political uncertainty in emerging markets has also scared away many investors because the government is often treated better than shareholders per se.

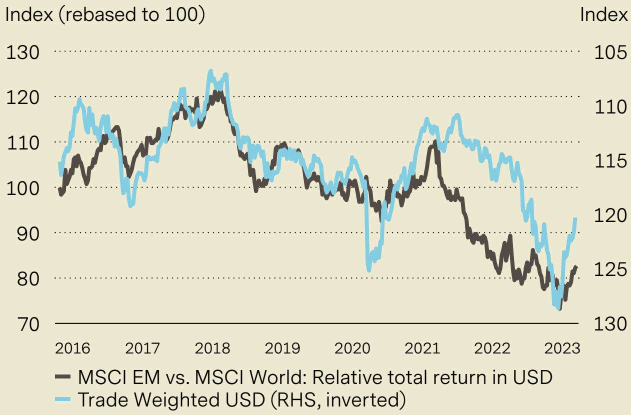
Both aspects, positive and negative, are likely to stay with us in the long run. Nevertheless, we believe that in the medium term, the worst of the underperformance is behind us. Over the last two years, emerging-market stocks have lost around 20 percent to developed-market stocks (see chart 1). The entry point could certainly be worse, especially because stocks in developed markets also fell significantly last year. The attractive valuation is one positive aspect. But the fundamental outlook is also improving, or it cannot get much worse. Consumer sentiment in China is at rock bottom because of the country's "zero-Covid" policy. But the government did a turnaround on its lockdown policy in late 2022. High-frequency data such as metro passenger values have rebounded strongly, confirming the reopening of the largest emerging economy. The regulatory situation has also eased in China. First, in the heavily pressured, most important industry: the housing market. The monetary floodgates have been opened again, and access to new credit for real estate developers has been facilitated. The crackdown on the big Chinese technology companies has also been eased. This is crucial for the emerging-market stock index, which now consists of many tech stocks, similar to the US. A recovering Chinese economy should also help other major stock markets in Asia, such as Taiwan and South Korea. Finally, the global big picture is also likely to change soon. Inflation levels are clearly coming back down, which should stop the Fed's restrictive policy. This could lead to a weaker US dollar, which in the past has been a tailwind for emerging-market equities (see chart 2). For us, this is reason enough to move away from our underweight position in emerging-market equities.

Chart 1: Emerging-market equities have underperformed for two years now



Source: Refinitiv Datastream, Vontobel

Chart 2: A weaker US dollar leads to an outperformance of emerging-market stocks



Source: Refinitiv Datastream, Vontobel

Time for a pulse check, Doctor Copper

—
Michaela Huber
Cross-Asset Strategist,
Vontobel

The red metal started the year on a strong footing, mostly due to positive cues coming out of China and other macro-related factors. Going forward, the rally could have some more room to run—but a lot depends on the "China story".

Copper is one of the most important base metals. It is not only used in many pockets of the world economy—among others, it is needed for power grids, building sites, and car fleets—but also plays a crucial role in the energy transition. Due to its widespread adoption, demand for copper is often considered a reliable indicator for predicting global economic health (hence the nickname Doctor Copper).

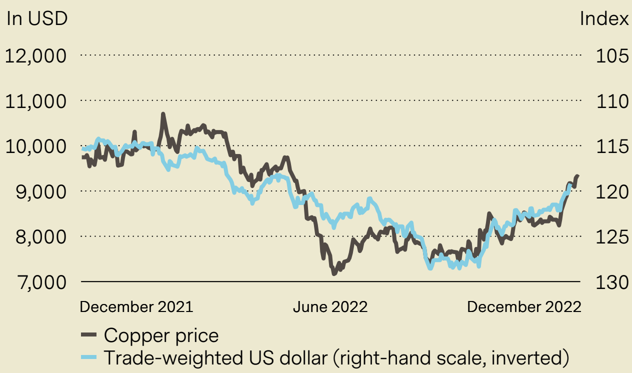
Improved demand picture vs. supply-side woes aplenty
Considering all the headwinds that plagued the world economy in 2022, it is no surprise that the PhD-bearing metal caught a sniffle and posted a 14 percent decline last year. In early January 2023, however, it surged above USD 9,000 per tonne, the highest level in six months (see chart 1).

This was mostly due to China- and macro-related factors. Not only did China, an avid metals consumer, end nearly three years of strict virus containment measures, but it also decided to lend a helping hand to its ailing real estate market (see "Market highlights" section on page 6). Apart from that, copper also received support from the peak in US inflation, hopes for a less aggressive Fed, and the weakening US dollar (like most commodities, copper is priced in US dollars—a softer greenback therefore means that it becomes cheaper for non-US buyers).

At the same time, copper markets face a set of supply-side challenges. First, as is the case for many commodities, copper markets have been subject to years of underinvestment. Second, visible copper inventories suggest that stocks have fallen to perilously low levels. Third, there are also country-specific challenges. Take top producer Chile, whose 2022 output was curbed by water issues and strikes, or the second-largest producer Peru, which is currently grappling with the worst social unrest in years after former President Pedro Castillo was ousted late last year.

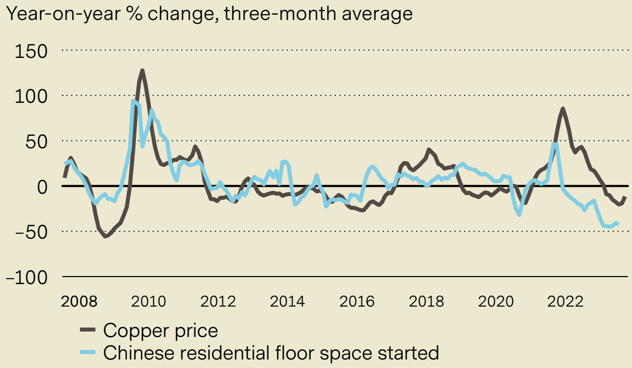
All these supply-side challenges depict considerable upside risks, which could propel copper prices even higher in the months ahead. However, we think that at the end of the day, the "copper story" is heavily geared towards the "China story". While the Chinese government's efforts to prop up its real estate market have thrown a lifeline to developers and stabilized the situation for now, more is needed to get Doctor Copper's pulse racing (see chart 2).

Chart 1: Copper got off to a head start in 2023



Source: Refinitiv Datastream, Vontobel

Chart 2: A successful turnaround of the Chinese property sector's woes is key



Source: Refinitiv Datastream, Vontobel

There are indications that the US dollar may have peaked

—
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After gaining about 25 percent since the summer of 2021, the US dollar has recently fallen considerably. Will this be the beginning of a new downtrend or do the supporting forces that pushed the dollar higher still prevail?

The strength of the dollar has been the main trend in the foreign currency markets last year. Although the Fed's rapid rate hikes and balance sheet reductions may have been the dominant factor in the dollar's strength, the greenback also benefited from safe-haven flows earlier in the year. The Fed's trade-weighted dollar index against key currencies was still up around eight percent in 2022, despite the fact that the dollar has generally weakened towards the end of the year.

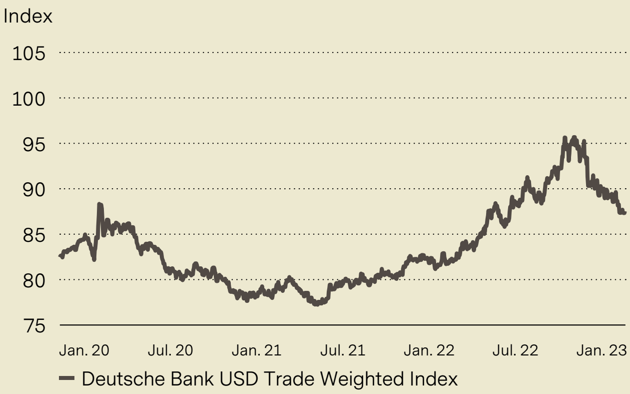
Growth momentum in the US is slowing and is expected to continue doing so, and the Fed is probably in the final stages of its tightening cycle. The relative yield differentials adjust accordingly and become less supportive of the dollar. All of this suggests that the tailwinds that helped the dollar rally are slowly fading. From a valuation perspective (based on the real effective exchange rate), the dollar is significantly overvalued, which also might suggest a reversal is overdue.

We realize that if the US economy experiences a severe downturn, there would be a demand for the dollar as a safe-haven currency. However, we see that as a risk scenario rather than a foregone conclusion. Rarely has the Fed over-tightened monetary policy to the point where it forced a hard landing for the US economy.

What about the euro?
Europe's terms of trade (the index used here measures the relative performance of commodity export and import prices) have taken a battering in 2022 (see chart 2), as energy import prices have ballooned. That has had a huge impact on current account balances, inflation, disposable incomes, and the euro. The surprisingly warm winter in Europe has seen natural gas prices plummet. The negative terms of trade shock that had been so bearish for the euro last summer has now completely reversed.

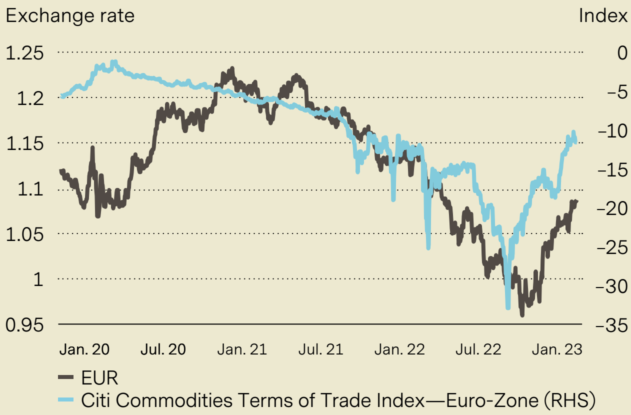
European growth will undoubtedly face headwinds from monetary tightening. So far though, European data continues to beat expectations, and incoming data trends suggest a need for continued hawkishness from the European Central Bank. The euro area's outlook is improving as energy prices fall, China begins to reopen its economy, and the Fed appears to be slowing its rate hikes. Surprisingly resilient European growth should keep the euro supported.

Chart 1: Trade-weighted US dollar off the highs



Source: Refinitiv Datastream, Vontobel

Chart 2: The negative terms of trade shock has now completely reversed



Source: Bloomberg, Citi, Vontobel

Economy and financial markets 2021 – 2024

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

GDP (IN %)	2021	2022	CURRENT[1]	2023 CONSENSUS	2024 CONSENSUS
Global (G20)	5.6	2.5	3.0	1.9	2.6
Eurozone	5.3	3.3	0.3	0.0	1.3
USA	5.9	2.0	1.9	0.5	1.2
Japan	2.3	1.3	1.5	1.3	1.1
UK	8.5	4.2	–0.3	–0.9	0.9
Switzerland	4.3	2.0	0.7	0.6	1.6
Australia	5.3	3.6	0.6	1.8	1.6
China	8.4	2.8	0.0	5.1	5.0

INFLATION	2021	2022	CURRENT[2]	2023 CONSENSUS	2024 CONSENSUS
Global (G20)	3.5	7.3	6.6	5.2	3.4
Eurozone	2.6	8.4	9.2	5.9	2.3
USA	4.7	8.0	6.5	3.8	2.5
Japan	–0.3	2.5	4.0	1.9	1.1
UK	2.6	9.1	10.5	7.1	2.5
Switzerland	0.6	2.9	2.8	2.1	1.2
Australia	2.9	6.5	7.3	5.1	3.0
China	0.9	2.0	1.8	2.3	2.2

KEY INTEREST RATES (IN %)	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR	–0.50	2.00	2.00	3.15	2.98
USD	0.25	4.50	4.50	5.05	4.30
JPY	–0.10	–0.10	–0.10	–0.09	–0.07
GBP	0.25	3.50	3.50	4.20	4.00
CHF	–0.75	1.00	1.00	1.44	1.39
AUD	0.10	3.10	3.10	3.60	3.35
CNY	3.80	3.65	4.35	4.30	4.25

GOVERNMENT BOND YIELDS, 10 YEARS (IN %)	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR (Germany)	–0.2	2.6	2.18	2.36	2.12
USD	1.5	3.9	3.50	3.65	3.32
JPY	0.1	0.4	0.39	0.44	0.44
GBP	1.0	3.7	3.37	3.50	3.17
CHF	–0.1	1.6	1.22	1.51	1.52
AUD	1.7	4.1	3.45	3.67	3.31

FOREIGN EXCHANGE RATES	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS END OF 2024
CHF per EUR	1.04	0.99	1.00	1.00	1.02
CHF per USD	0.91	0.94	0.92	0.93	0.92
CHF per 100 JPY	0.79	0.72	0.71	0.73	0.74
CHF per GBP	1.23	1.12	1.14	1.14	1.14
USD per EUR	1.14	1.06	1.09	1.08	1.10
JPY per USD	115	130	130	130	125
USD per AUD	0.73	0.67	0.70	0.69	0.72
GBP per EUR	0.84	0.88	0.88	0.88	0.89
CNY per USD	6.37	6.91	6.79	6.80	6.68

COMMODITIES	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
Brent crude oil, USD per barrel	79	86	88	89	88
Gold, USD per troy ounce	1,829	1,824	1,926	1,783	1,844
Copper, USD per metric ton	9,720	8,372	9,324	8,302	8,450

[1] Latest available quarter
[2] Latest available month, G20 data only quarterly
Source: Vontobel, respective statistical offices and central banks; as of January 23, 2023

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