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Compass

2nd Quarter 2023

Your wealth, our responsibility.

Moderate growth despite uncertainties

The consequences of the Ukraine war and the fight against inflation are likely to continue to shape the global economy this year and accordingly lead to low growth expectations. Core inflation is currently well above the pre-pandemic level, which is why central banks are holding out the prospect of further key interest rate hikes. As the growth rate has not yet declined, we consider interest rate cuts unlikely in the near future. However, the confidence and liquidity crisis in the US banking sector is a first hurdle for the Fed's interest rate hike policy. Last year, the US dollar proved strong against many currencies. Now, in the wake of a possible dollar devaluation, various emerging markets could benefit and reduce their debt burden. Compared with industrialised countries, many of the emerging markets are at different stages of their fiscal policy cycles and could act as growth drivers in the future. The regime of secular stagnation, which is favorable for financial markets, seems to be challenged by negative supply shocks resulting from the COVID pandemic and the Ukraine war. While we consider the fears of structural stagflation like in the 1970s as unfounded, the clearly negative real interest rates of the past decade are likely to be history. However, mainly due to the persistently high private savings rate, real interest rates will probably remain below the potential economic growth rate in the future.

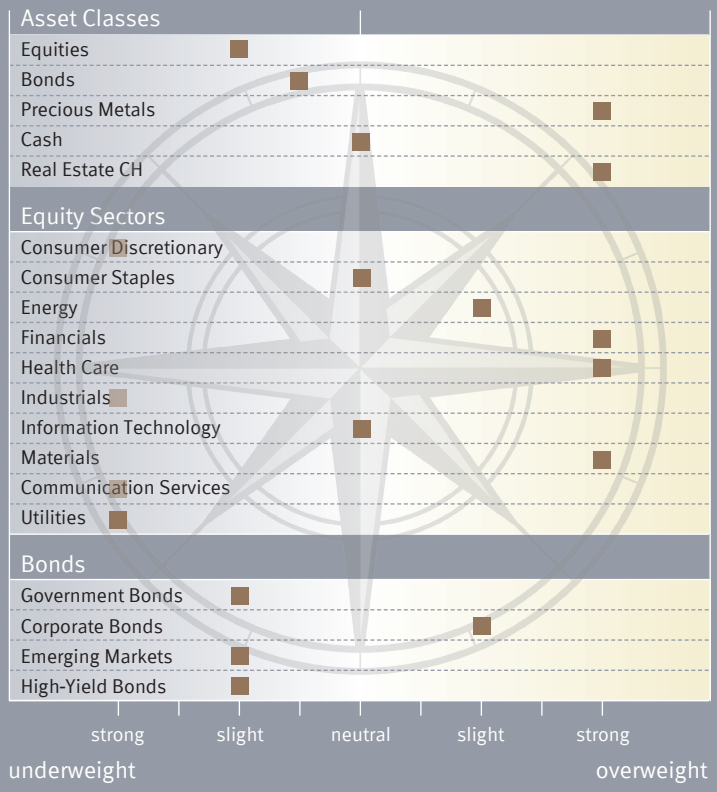
Unchanged tactical allocation

Hoping for an end to interest rate hikes in the near future, global stock markets got off to a buoyant start to the new year and by the end of January had recovered some of their losses from the previous year. However, from mid-February at the latest, it became apparent that macroeconomic uncertainties were not yet off the table. A persistently strong labor market and inflation rates still at very high levels put a damper on the upswing and brought volatility back to the financial markets.

Our slight underweighting of equities has proven beneficial in this market environment. Increasing the weighting of the IT sector and reducing the weighting of the interest rate-sensitive utilities sector turned out to be equally positive. With our current equity allocation, we believe ourselves to be well positioned to generate additional value in these times of uncertainty. There have therefore been no tactical adjustments since the last Compass issue.

Our allocation to bonds also remains unchanged at an underweight. We recommend critically scrutinizing the credit quality of issuers and only holding bonds from first-class borrowers. In addition, we continue to appreciate the defensive nature of gold and maintain its strong overweight.

Asset allocation recommendation as of April 1st, 2023 for investors with CHF as their reference currency.

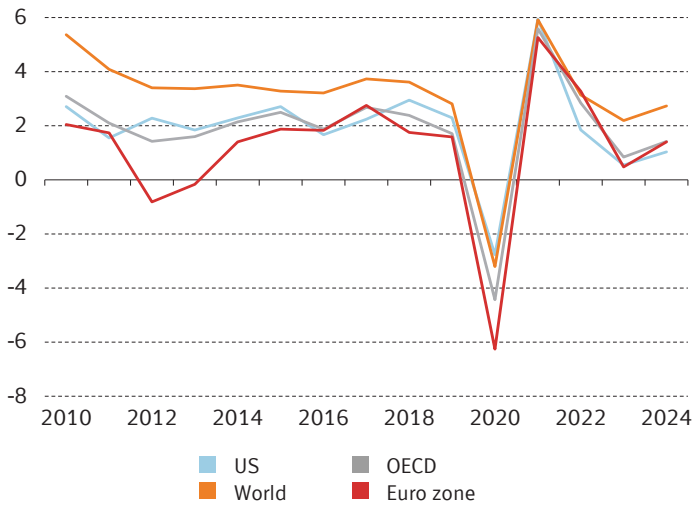


Current Topic:
An uncertain situation

Current Topic 1:

Source: OECD

Annual real GDP growth in percent

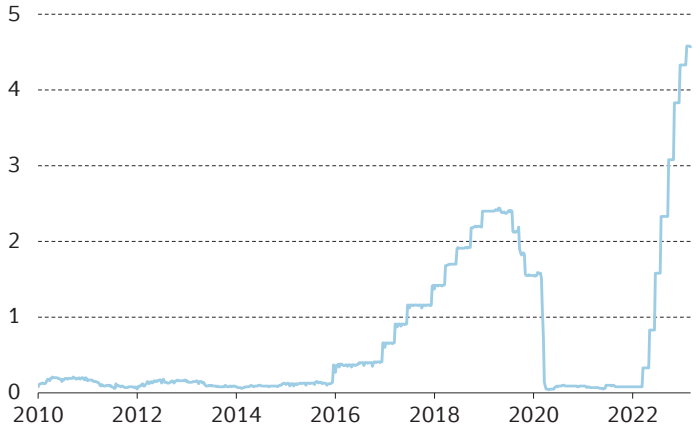


Low global growth forecast

In 2022, inflation, the Ukraine war and a resurgence of COVID-19 in China weighed on global economic activity. Nevertheless, real GDP in many economies was surprisingly strong thanks to unexpectedly robust private consumption, tight labor markets and fiscal stimulus. Falling transport costs and easing bottlenecks reduced pressure on input prices, thus supporting the upswing. In addition to the mild winter and low natural gas prices, China eased its zero COVID policy and delivered new approaches to restore confidence in its real estate markets, providing relief. Nevertheless, growth is expected to be low in 2023 as the consequences of the Ukraine war and the fight against inflation continue to weigh on the global economy.

Current Topic 2:

Effective federal funds rate in percent

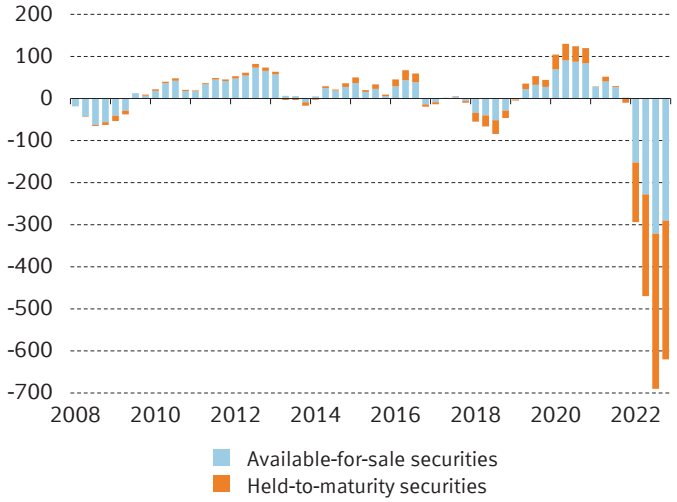


No interest rate cuts for now

To combat high inflation in this surprisingly robust economic environment, the Fed and the ECB raised their interest rates faster than expected. As a result, demand gradually cooled, causing overall global inflation to decline since Q3 2022. To capture the underlying inflation trend of an economy, inflation is adjusted for volatile factors such as food and energy prices. This so-called core inflation remains well above pre-pandemic levels. Both central banks are therefore holding out the prospect of further interest rate hikes. As key rates are usually only lowered as soon as the growth rate falls, the expectation of timely rate cuts is too optimistic in our view.

Current Topic 3:

Unrealised gains/losses on investments of US banks in USD billions

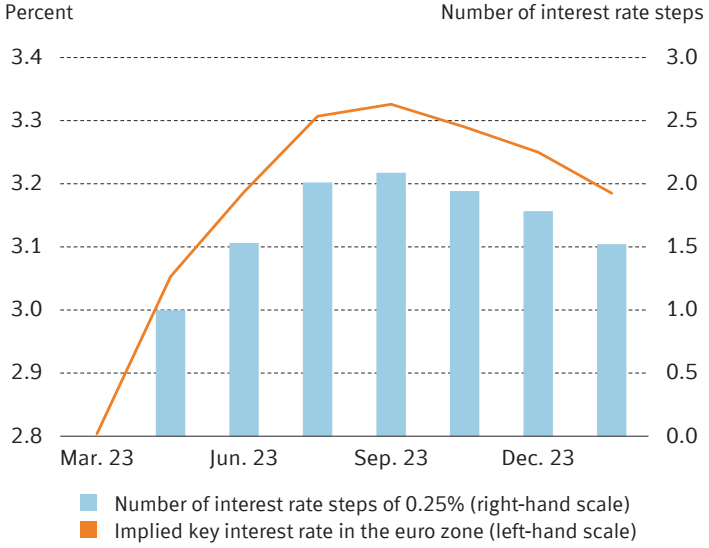


Effects of the interest rate hike policy

A first hurdle for the Fed's interest rate hike policy arises from the recent crisis of confidence in the US banking system. Because of rapidly rising interest rates, banks' bond holdings have depreciated and liquidity has been squeezed, culminating in a bank run and the collapse of one and closure of other US regional banks. Regulators took swift action to maintain liquidity and confidence in the banking system. Compared to US banks, European banks have less interest rate risk on their books. However, they often hold government bonds of their home country, which poses an increased credit risk, especially for banks in Southern European countries. If the ECB were to impose further interest rate hikes, this could lead to a liquidity shortage for European banks.

Basic Trend:
Relevance of the US dollar and inflation expectations

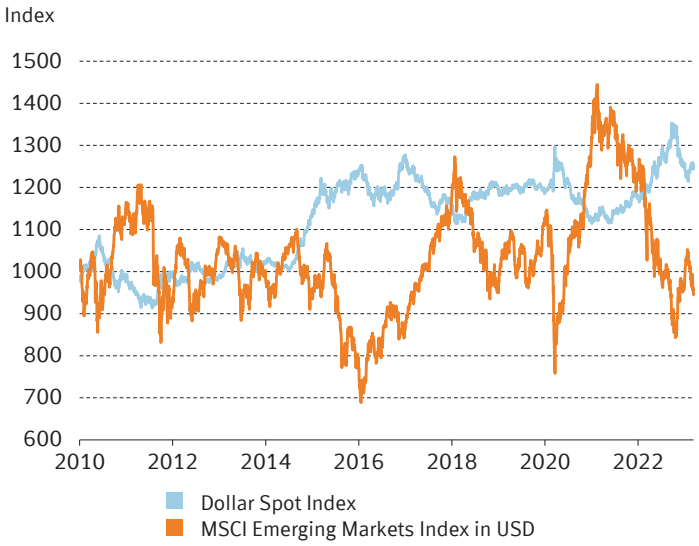
Basic Trend 1:



The end of dollar strength?

The US Dollar Spot Index, which measures the strength of the dollar against a basket of currencies, rose more than 12% in 2022, trading at its highest level in 20 years in September. The main driver of the appreciation has been faster and larger interest rate increases, which have made investing in US government and corporate bonds more attractive relative to other currency areas. However, the weakening effect of dollar strength on US inflation is negligible due to pronounced domestic consumption. At present, the US has slowed the pace of interest rate hikes, while large interest rate steps are still on the horizon in the euro zone. Therefore, the dollar could weaken again versus the euro in the near future.

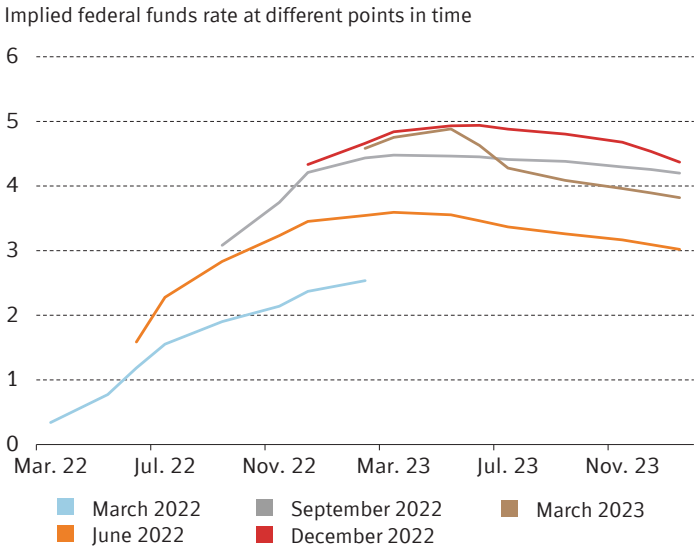
Basic Trend 2:



Will emerging markets benefit?

The strength of the dollar is increasingly becoming a risk factor for developing and emerging economies with high levels of USD debt or strong US foreign trade relations, putting a strain on the stability of their domestic financial systems. A rising dollar leads to an increase in debt burdens and interest payments, measured in local currency. Compared to developed markets, many emerging markets are in different phases of their business cycles and tend to have higher population growth, which can offer attractive investment and diversification opportunities. It is worth mentioning that there are major economic differences between the countries and that the situation can only ease in the longer term through a sustained weakening of the US dollar.

Basic Trend 3:



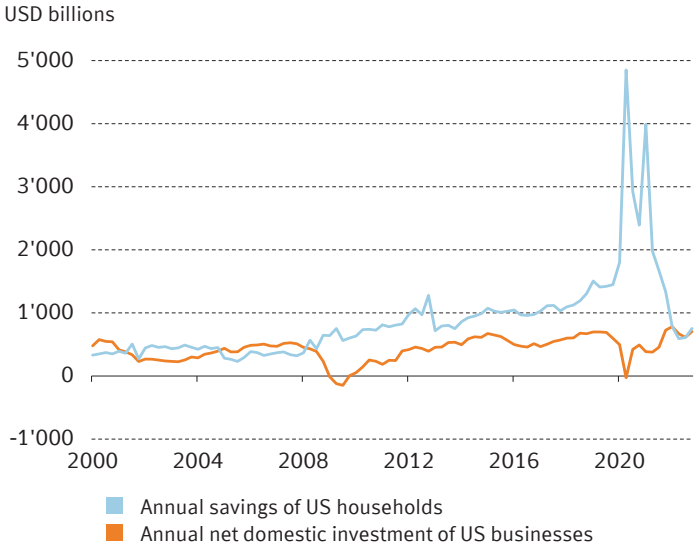
Reasonable inflation expectations

In response to various macroeconomic developments, households, firms and financial markets form inflation expectations. These inflation expectations are an important decision-making factor and objective for central banks, although they may differ from actual observed inflation. If inflation expectations are higher than measured inflation, workers demand higher wages and firms set higher prices than measured inflation would require. The resulting general increase in prices causes workers to demand higher wages again, to which firms respond with higher prices once more. This can intensify measured inflation and lead to a wage-price spiral. At present, it appears that central banks have been relatively successful in dampening inflation expectations.

Knowledge & Experience: The end of secular stagnation?

Knowledge & Experience 1:

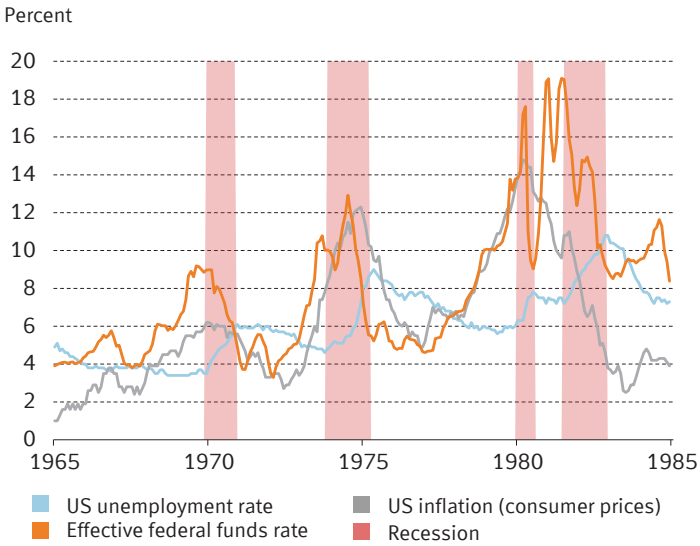
Source: St. Louis Fed



Secular stagnation was a blank check for central banks

Due to chronic underdemand resulting from high private savings rates and low corporate investment, economist Lawrence H. Summers described in 2013 the Western economies as being in secular stagnation. Negative real interest rates far below the economy's potential growth rate were needed to ensure full employment. Freed from inflation concerns, central banks were able to devote their expansionary monetary policies entirely to reducing unemployment. Thanks to weak wage growth and low capital costs, companies enjoyed high profit margins. Long-term investments, especially growth stocks, have profited from the steady decline in real interest rates. Does rampant inflation now mark the definitive end of this investor-friendly regime?

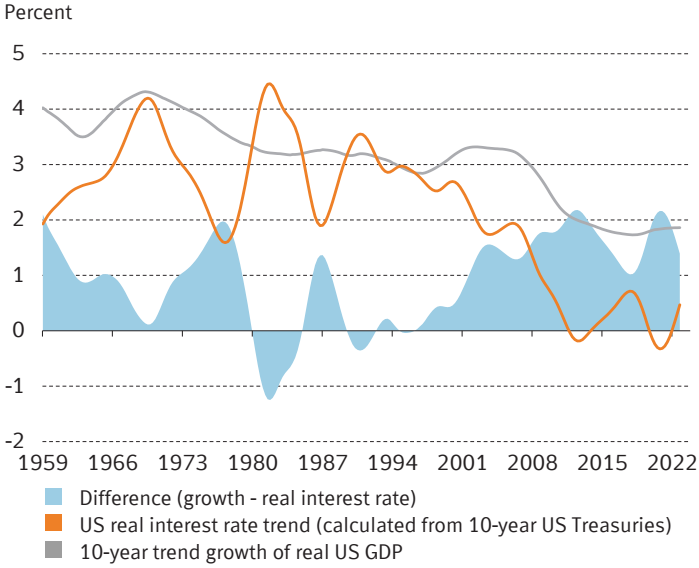
Knowledge & Experience 2:



Is a stagflation looming like in the seventies?

Similar to the COVID pandemic and the Ukraine war, an oil embargo in the 1970s led to a negative supply shock. At that time, the dramatic rise in oil prices had hit the then energy-intensive US economy with full force. The Fed's measures directly triggered a recession. Companies were almost exclusively dependent on the banking system for refinancing. Since "Regulation Q" had set interest rate ceilings on sight deposits, these funds flowed into money market funds when key interest rates rose – with fatal consequences for bank lending. Probably because of the strong unions, wage pressure eased only slowly despite rapidly rising unemployment. Before disinflation set in, the Fed had to keep the real interest rate far above economic growth for a long time.

Knowledge & Experience 3:



Neutral real interest rate and real growth

Today, the tasks for central banks seem more manageable. In the years ahead, the difference between the real interest rate, which is neutral for price stability, and potential economic growth will be decisive. The high need for savings, due to increased life expectancy and rising income inequality, argues for a continued low real interest rate. Upward pressure comes from higher government debt and rising investment demand in the areas of defense and energy transition as well as for production shifts away from China. These investments are also beneficial to real growth, but only to a lesser extent. Production growth from artificial intelligence and robotics is more likely. In sum, growth should continue to outpace the real interest rate, but to a lesser extent than in the past. We will discuss the implications for investors in the next Compass issue.

The prices used in our analysis are end-of-period prices. The figures used for our valuation model are estimates referring to dates and therefore carry a risk. These are liable to change without notice. The usage of valuation models does not rule out the risk that fair valuations over a specific investment period cannot be attained. A complex multitude of factors influences price developments. Unforeseeable changes could, for instance, arise from technological innovations, general economic activities, exchange-rate fluctuations or changes in social values. This discussion of valuation methods makes no claim to be complete.

Dreyfus Sons & Co Ltd publishes Compass four times a year since June 2008. The publication is aimed at clients of the bank and interested parties. It describes some of the instruments and methods the bank uses to monitor everything to do with the financial markets. A description of the investment process can be obtained from your client advisers or our website. Compass provides guidance but cannot take the circumstances of an individual portfolio into account. It is for information and marketing purposes.

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