J. SAFRA SARASIN

SUSTAINABLE ASSET MANAGEMENT

CIO Update

Investment Committee Bank J. Safra Sarasin
11 February 2022

The fight against inflation

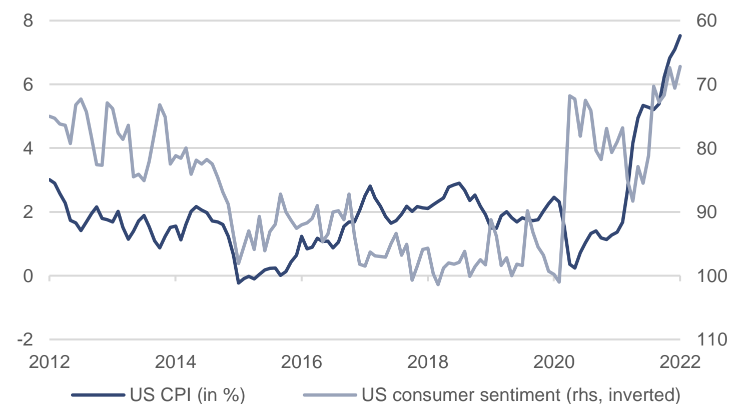
Central banks take up the fight against inflation. Financial markets are shaking. Uncertainty remains high.

Macro outlook – Central banks change their communication
The beginning of this year was characterized by a high level of uncertainty. While the omicron wave weighed on economic activity in the short term, other factors also dampened sentiment. Geopolitical risks due to the conflict between Ukraine and Russia, a sharp rise in oil prices, labor shortages and continued high inflation rates are causing concern among governments and central banks and are leading to high uncertainty in financial markets.

The US Federal Reserve was forced to acknowledge at the end of November that the sharp rise in inflation rates was unlikely to be a merely temporary phenomenon after all, and once again has become more hawkish in its communication at the latest meeting of the Federal Open Market Committee. With his references to the robust economy and the very strong labor market and his comment that it was appropriate to tighten monetary policy more quickly in view of high inflation rates, Fed Chairman Jerome Powell had clearly exceeded market expectations regarding future interest rate hikes.

High inflation rates have become a political issue, and not only in the US. In the euro zone, the inflation rate rose to 5.1% in January, far above market expectations. Economists had already begun to question the wait-and-see attitude of the European Central Bank. And indeed, ECB President Lagarde emphasized the upside risks to inflation more strongly. Although she gave some indication that no interest rate hike was to be expected any time soon, she also refused to confirm an earlier statement by the ECB, according to which a first interest rate hike as early as this year was "very unlikely". In any case, private households are feeling the impact of the price increases directly, which is having a correspondingly negative effect on consumer sentiment.

High inflation rates weigh on consumer sentiment



Source: Refinitiv, J. Safra Sarasin, monthly data, June 2012 to January 2022

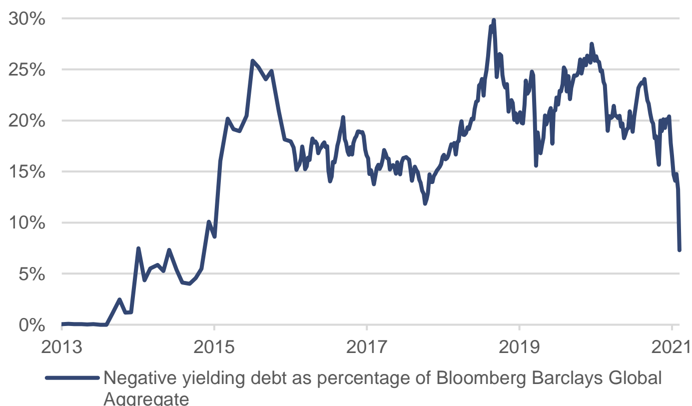
Editorial
Dear Reader

After ignoring the high inflation rates as transitory for a long time, the central banks have now woken up from their hibernation. Even the European Central Bank no longer rules out an interest rate hike this year, and one hike is now quite possible in Switzerland as well. Central banks have taken up the fight against inflation and are now doing everything they can to regain their credibility. Therefore, collateral damage with further setbacks in financial markets is quite possible. However, thanks to continued positive growth figures, the environment for equities should remain positive in the medium term. The right selection is crucial, and patience is needed to wait for tactical opportunities.

Philipp E. Bärtschi, CFA, Chief Investment Officer

Bonds – Regime change
In the government bond markets, these developments have led to substantial losses on both sides of the Atlantic since the beginning of the year. Both US Treasury and Bund yields are at their highest levels since the outbreak of the pandemic. For the first time since May 2019, the yield on ten-year Bunds rose above zero percent. Their Swiss counterpart also offers investors a positive nominal yield for the first time since November 2018. The share of negative-yielding investment-grade bonds has fallen significantly since December. At this rate, there may be no more bonds with negative yields very soon.

Share of negative-yielding bonds has collapsed



Source: Bloomberg, J. Safra Sarasin, weekly data, 2.7.2011 to 4.2.2022

Although still low in a historical context, credit spreads on the bond markets have also risen recently. The moderating growth environment in conjunction with the beginning rate hiking cycles of major central banks is a burden. However, economic growth, albeit moderating, is still at a high level and should therefore allow positive returns in the medium term. High-yield bonds also have a relatively low duration, which makes them more robust in the face of interest rate hikes. In addition, the technical environment is sound: default rates are at a very low level and corporate fundamentals are in good shape.

Equities – Strong differentiation between sectors and styles
Some of the price declines in global stock markets in recent weeks have been very significant. Combined with extremely high daily volatility, the nervousness and uncertainty on financial markets was all too noticeable. Growth stocks in particular came under selling pressure. And because rising interest rates hurt growth companies more than value stocks, the prospect of an imminent interest rate turnaround also contributed to a strong rotation within equity sectors and styles. Selectivity at sector and style level is therefore particularly important for investment success in equities this year.

Asset Allocation – Volatility brings opportunities
It is truly an uncomfortable start to the year in financial markets. High COVID-19 case numbers, geopolitical risks in Eastern Europe, a reversal of the ultra-expansive monetary policy of the past decade and an imminent interest rate turnaround have already led to considerable uncertainty and have continued negative surprise potential.

The biggest concern, however, is inflation. It is likely to take a while for central banks to get a grip on inflation. As long as they continue to tighten their rhetoric and raise their interest rate and inflation forecasts at every meeting, volatility in financial markets is likely to remain high. Rising real interest rates are weighing on the valuation of all financial assets, so that even traditionally safe bonds no longer offer any protection. Against this backdrop, we have increased the cash quota in the portfolios in order to be able to benefit from possible tactical opportunities. Patience is required, however, as the current risks will not disappear in the near future.

Due to the prevailing uncertainty, we have recently reduced our allocation to equities, but remain slightly overweight, as the economic environment should improve in the second half of the year and inflation concerns should increasingly take a back seat. Within the asset class, we favour emerging market equities. The economic and monetary policy environment in the region, and especially in China, is supportive, and many regional central banks are already significantly more advanced in their rate hiking cycle.

We are underweight in bonds. Interest rates are likely to continue to rise and high-duration government and investment-grade bonds will remain under pressure. We have reduced duration risk accordingly in recent weeks. We still prefer high-yield and emerging market bonds in this environment due to their better risk-return profile. The tighter monetary policy is likely to become a burden for the credit markets as well. However, as long as growth remains robust, the positive fundamentals should prevail and lead to a solid performance based primarily on the higher carry.

We are maintaining our overweight in alternative investments. The low correlation of returns with those of traditional asset classes contributes positively to portfolio diversification, especially in this highly uncertain investment environment.

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Attractiveness of individual investments

Asset class	Weighting	Relative attractiveness within the categories			
Equities	=/+	Developed markets –	Emerging markets +	Large caps =	Small caps =
Bonds	– –	Government bonds – –	Corporate bonds – –	High-yield bonds +	Emerging markets +
Alternative assets	+	Money market +	Convertible bonds +	Other alternatives +	Real Estate =

Source: Refinitiv, J. Safra Sarasin

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