J. SAFRA SARASIN
SUSTAINABLE ASSET MANAGEMENT

CIO Update

Investment Committee Bank J. Safra Sarasin
9 June 2022

Don't fight the Fed

Restrictive central banks and high inflation rates are likely to continue to weigh on the economic outlook.

Macro outlook – The US Federal Reserve stays its course
High inflation rates are increasingly permeating global economies, and sharp increases in commodity prices are just one aspect of this development. This is exemplified by the latest inflation data from the USA, where core inflation (i.e. the rate of inflation excluding energy and food components) continues to surprise on the upside. It recently rose by 6.2% year-on-year, once again exceeding economists' expectations. At the same time, wage costs are rising, not only in the USA, which is contributing additional price pressure. In the euro zone, inflation also rose sharply recently, by 8.1% year-on-year in May. Price pressures at the producer level therefore remain correspondingly high.

This is likely to worry central banks, as considerable determination will be needed to put a stop to these developments. The monetary policy measures, in turn, are likely to lead to a slowdown in economic activity sooner or later. Significant price increases are already weighing on consumer confidence, and rising mortgage rates are likely to be reflected in a cooling of the housing market. Despite weaker macroeconomic data, the US Federal Reserve remains aggressive in its communication and interest rate hikes of 50 basis points in both June and July seem most certain. In any case, the new vice chair of the Federal Reserve Lael Brainard sees no reason to turn away from the steep interest rate path she is aiming for and believes financing conditions are not yet at a worrisome level. ECB Director Schnabel takes a similar view: "Now it's no longer enough to talk, we have to act." She believes an interest rate hike in July is possible. But the instruments of monetary policy are relatively blunt and their effect can only be assessed after months. Therefore, it is not surprising that monetary tightening leads to "hard" landings much more often than "soft" landings.

At the same time, the economic development in China remains highly uncertain. Although the government has eased some of the strictest measures under its Zero COVID policy, the restrictions are still massive and so is the impact on global supply chains. This was recently reflected in correspondingly weak data on industrial production, retail sales and the real estate sector. The slump in retail sales and industrial production was the sharpest since March 2020. Against this backdrop, the Chinese government's growth target of 5.5% appears quite ambitious and is unlikely to be achieved.

Editorial

Dear Reader

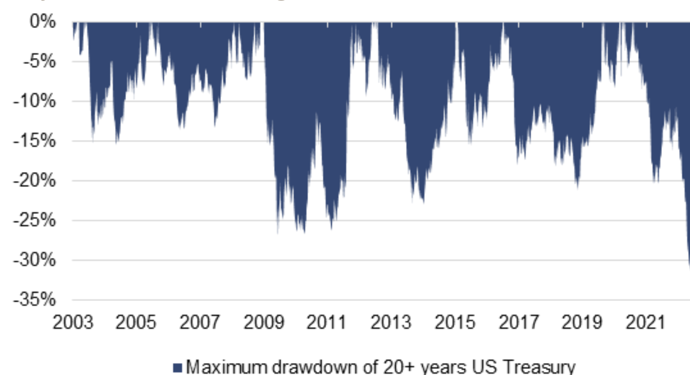
Equity markets have been in a downward trend since the beginning of the year, even though in between there have been repeated countermoves, followed by further setbacks. Inflation seems to be slowly reaching its peak, but growth concerns are now coming to the fore. This combination should support the bond markets in the medium term and calm interest rates. We have therefore raised the bond quota in our portfolios to neutral. We remain cautious on risk assets and are waiting for better buying opportunities. As long as central banks continue to turn off the taps, risk assets are likely to remain in an uncomfortable situation.

Philipp E. Bärtschi, CFA, Chief Investment Officer

Bonds – Once again an alternative

The structural low interest rate environment has started to crack. Persistent inflation risks and the prospect of a normalization of monetary policy conditions have led to significantly higher interest rates in recent months. The pronounced reassessment of monetary policy expectations in fixed income markets has been dramatic, and losses have been correspondingly high. However, the risk-return profile from an investor's perspective has also improved significantly in the process, making bonds a genuine investment alternative and risk diversifier for the first time in years.

Major drawdowns for long-dated bonds



Source: Refinitiv, Bank J. Safra Sarasin, weekly data, 1.1.2003 to 1.6.2022

Now, however, investors are increasingly focusing on the risks of a recession. Fed Chairman Powell recently announced that the intended monetary policy course would be associated with "economic pain" for the world's largest economy. This should limit the rise in interest rates in the government bond market in the medium term.

Equities – Key indicators show mixed picture

In the equity markets, this has recently had a negative impact on expectations for corporate earnings, and thus on the fundamental backbone of equity markets. One of the biggest surprises in recent weeks has certainly been the disappointing earnings as well as declining margins of the major US retail companies. Not least because these companies provide a direct insight into the health of the US consumer.

Further developments in global equities markets remain highly uncertain and are likely to remain volatile. This is also reflected in the divergent development of three important indicators for the equities market: semiconductors, small caps, and transportation stocks, which together paint a mixed picture. All segments are sensitive to economic developments. And while the semiconductor segment has recently broken its downward trend that has been in place since the beginning of the year - after all, there are signs that the chip crisis is easing and demand remains strong - small cap companies remain depressed. Transportation stocks, on the other hand - long an indicator of the broad market - do not provide a clear direction and offer little insight. Ultimately, these indicators are a reflection of the very high uncertainty in global equities market, with investors viewing any tentative recovery with great suspicion, but at the same time not expecting the indices to fall to new lows.

Mixed signals in equities markets

Source: Refinitiv, Bank J. Safra Sarasindaily data, 1.3.2021 to 6.6.2022

Asset Allocation – Reduce risks

The normalization of monetary conditions is likely to weigh further on economic developments. The question is how well consumers and companies will cope with the economic slowdown and whether sentiment is already so negative that opportunities will start to arise. It is probably still too early for that. As the saying goes: "Don't fight the Fed." And the Fed seems to be more than willing to fight inflationary dynamics. We have therefore used the recent rebound in equities markets to further reduce the equities allocation in our multi-asset portfolios. Within the asset class, we remain defensively positioned. Low-beta, dividend strategies and quality are proving to be relatively robust in this mix. At the sector level, we continue to favour defensive sectors.

We increased our bond allocation by purchasing high-quality bonds. The recent sharp rise in interest rates has offered attractive opportunities in this segment. Inflation-hedged bonds also continue to appeal to us. We have reduced credit risks by cutting back on high-yield bonds.

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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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