Outlook for 2023: Investing protects purchasing power

Inflation triggers a paradigm shift for investors

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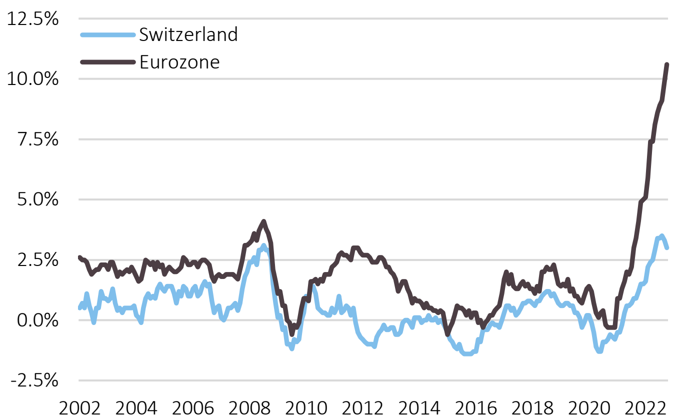
Following two years dominated by the pandemic, 2022 should have marked a return to business as usual. However, these expectations were dashed by the Russian invasion of Ukraine. Alongside massive human suffering, inflationary pressure increased as a result and the economic environment became increasingly challenging. China's insistence on its strict "zero Covid" policy meant that supply chains did not fully normalize, limiting the supply of certain types of goods. This forced central banks to tighten monetary policy by hiking interest rates, following an extended period of excessive hesitance. This environment characterised by rising interest rates led to a sell-off in financial markets. Alongside equity markets, bond markets were also particularly affected by this.

We anticipate **inflation** to ease during the course of 2023 and the pace of interest rate rises to decrease. On the other hand, inflationary factors such as geopolitical tensions and government interventions are expected to continue to apply over the longer term. Demographics and the increasingly regional focus of businesses will also have an inflationary effect. Globalisation, which tends to be deflationary, reached its high point – for the time being – before the pandemic. This means that inflation could end up being more persistent than we might like it to be, levelling out at a higher rate.

Graph 1: Inflation – Switzerland and the Eurozone*



*Source: Blomberg, Belvalor; * Monthly Consumer Price Index (CPI)*

Some indicators give us grounds for optimism over the medium to long term. For example, capital is once again earning interest. There are some initial signs that inflation is easing. Central banks will apply the brakes harder in order to bring inflation back down to a tolerable level and to re-establish price stability. However, an extended period of high inflation and high interest rates could still be on the cards. The new **interest rate equilibrium** will still be relatively low by a historical comparison. Financial repression – essentially the expropriation of savers – has been ongoing for some time and is set to continue. Investors continue to have a pessimistic outlook, although much of the negative news has already been priced in by equity markets. Driven by positive long-term growth prospects, a seemingly turbulent 2023 on the equity markets could thus ultimately turn out to be a good year after all.

<u>The key point:</u> Investors have to focus on protecting **purchasing power**. Rather than being directly reduced by negative interest rates, the value of your money will be eroded by inflation. This is insidious as nothing like this has happened for a very long time. Nominal assets will be devalued, which is actually only beneficial for debtors. Although positive interest rates moderate the negative real interest rates – as inflation is outpacing interest rates – they do not provide sufficient protection against inflation. Assuming an inflation rate of 3–4% per annum, any money that is not invested will only be worth half as much in 20 years.

Some real assets, in particular equities, can provide suitable protection against inflation. Over the long term, corporate profits are rising thanks to innovation, pricing power and productivity gains. Despite the various negative developments and the economic downturn, corporate profits grew globally by 10% in 2022. Investors became painfully aware in 2022 that equities can be volatile and that a long-term perspective is required. One positive aspect of this scenario characterised by higher corporate profits and lower equity market prices is that equities have now become cheaper, and thus are more attractive.

Economic environment

The economic recovery continued in 2022, driven by demand. However, supply struggled to keep up. Until now, companies have been able to pass on the significant increases in the costs of input factors such as energy and raw materials in the form of price hikes. As a result, corporate profits have also recovered further.

However, salaries and wages are now starting to rise after a lag, as a consequence of inflation and the labour shortage. Staff costs will weigh on margins in 2023. Any further price increases in order to defray additional costs will be less likely to be accepted, resulting in declining revenues and lower economic growth. In terms of the economic cycle, 2023 is set to be characterised by headwinds and a temporarily selective dynamic with declining corporate profits.

Global economy experiencing headwinds due to rising costs

Stimulus packages, which have not been implemented yet, will have a positive effect. Coupled with planned investments as part of the energy transition, a state-driven wave of investments could be triggered, above all in the USA and Europe. Eco-friendly policies are not only reliant on but also promote technology and innovation. Necessity is the mother of invention – and all at once we are seeing action rather than words. The flipside is that such initiatives have an inflationary effect.

Asia and the Pacific region are suffering from China's "zero Covid" policy, which was unsustainable over the long term. The policy is being eased in slow steps, although all in all will have positive effects throughout the region. However, the Chinese government will continue to direct and control the country's economic policy. The USA is taking advantage of China's restrictive policy and supply chain bottlenecks in order to invest in independence and self-sufficiency through restrictions and sanctions on the one hand as well as domestic subsidies on the other hand. This "reshoring" – the repatriation of production facilities from developing countries back to industrialised countries – will not only affect China, but will also lead to a further unwinding of globalisation.

State-driven wave of investments in infrastructure and the energy transition

Global growth will slow down further in the medium term. A recession, or a recessionary environment, will emerge in a number of regions during the first half of 2023. However, economies will start to recover again thanks to the input from state-run investment programmes – focusing on infrastructure and energy in the USA and Europe. We consider geopolitical tensions, especially China's approach to Taiwan, to be the biggest risk. Inflation will continue to be an inseparable companion. The challenge will be learning to live with a higher level of inflation. An economic recovery is anticipated from summer of 2023, with a return to long-term global GDP growth rates of 3.0–3.5% per annum being possible from 2024 onwards.

The USA will stick unswervingly to its current course. Europe is more united than it was before the pandemic, in part out of necessity and in part due to the current crisis. Despite more widespread trends towards nationalisation, Switzerland and its innovative companies will find a way to profit from the recovery and the wave of investments. Companies from exporting sectors and tourism have been particularly affected by the strong Swiss franc, although have learned how to deal with it.

Currencies

There have been major shifts on the currency front. Interest rates have risen extremely quickly for all of the major currencies, including the Swiss franc. They will come down again once inflation has been brought under control. As a result of lower inflation and stronger economic fundamentals, the Swiss franc will experience further upward pressure.

Swiss franc still most attractive currency – positive impetus from USD weakness

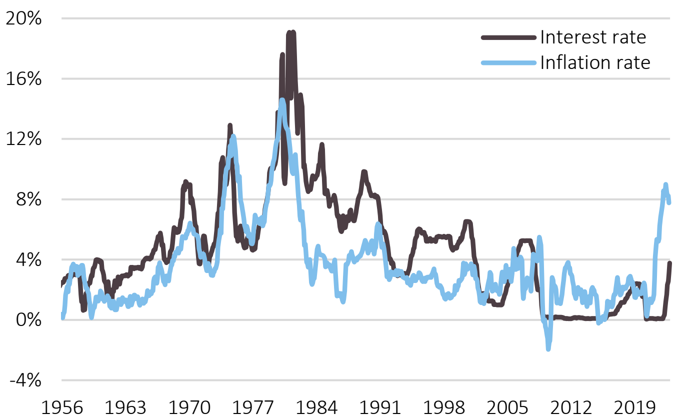
The US dollar and the Swiss franc have benefited from their status as safe-haven currencies. The US dollar has appreciated strongly on the back of uncertainty, a weaking economy and the US Fed's tight monetary policy. We are therefore anticipating the US dollar to come under pressure in tandem with brightening global economic prospects and/or any easing of geopolitical tensions. In terms of the economic fundamentals and after being adjusted for purchasing power, the US dollar is overvalued. A weaker US dollar with a narrowing positive interest rate differential will enable the euro and developing country currencies to recover. The euro remains structurally weak due to sustained political instability within the Eurozone. The British pound has lost the allure of yesteryear and is morphing into a soft currency. We still recommend minimising currency risks. This applies in particular for investors whose reference currency is the Swiss franc.

Interest rates / bonds

The interest rate landscape has completely changed over the past 12 months. First the positive change: investors are earning positive interest again. This is highly appreciated after years of zero or negative interest rates.

Once again, the Fed has nosed ahead of the pack of central banks. The Fed was in fact the first larger central bank to start raising interest rates and, until now, has been unequivocal in signalling to the financial markets that combatting inflation is the number-one priority. The Swiss National Bank (SNB) finally brought an end to its negative interest rates after seven long years in September, doing so before the European Central Bank (ECB). We welcome this development since, from our perspective, the adverse effects of negative interest rates were becoming increasingly clear, the longer the policy continued. We are expecting the SNB to raise the policy rate at most to the 1.5–2.0% range.

*Graph 2: Interest rate vs. inflation rate in the USA**



*Source: Federal Reserve Economic Data (FRED®), Belvalor; * Interest rate: Federal Funds Effective Rate; Inflation rate: Consumer Price Index*

Despite rising interest rates, all of the major Western currencies still face the problem of negative real interest rates. Inflation is higher than nominal interest rates. The market is continuing to assume that the current high inflation rates will be temporary, and that inflation will fall over the medium term. We consider this to be an accurate forecast for 2023 and expect inflation rates to fall due, amongst other things, to an economic downturn. However, from a longer-term perspective, we do not think that inflationary pressure has been warded off entirely. Structural energy shortages and the plans to invest in immense infrastructure projects will require resources, which are becoming increasingly scarcer. In addition, many economies are experiencing labour shortages, putting upward pressure on salaries.

Some segments of the bond market have become significantly more attractive as a result of rising interest rates and higher credit spreads. In the current environment, corporate bonds denominated in Swiss francs, euros or US dollars with maturities of up to five years appear to us to be a valid option within a diversified portfolio. We are avoiding longer maturities as the risk of substantially higher inflation expectations has not been taken off the table entirely. Following the recent interest rate hikes, bonds issued by creditors with a good credit rating seem to offer the most suitable option for achieving diversification and risk reduction in an investment portfolio.

In addition to selective direct investments, some special segments on the bond market appear attractive to us. These include cat bonds and convertible bonds via selected collective instruments. However, quality and liquidity are important considerations for any investment in an economically challenging environment.

Equities

Equities are real assets, and thus particularly attractive for investments in the current environment characterised by financial repression. This explains amongst other things why we did not significantly change our investments in equities in 2022 and took advantage of lower prices to add to positions.

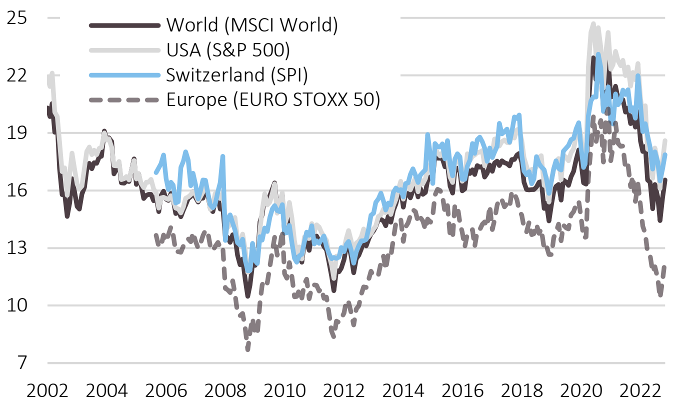
The long-term performance of equities is driven by the cashflow generated by companies. Despite the negative performance of numerous equity indices, corporate profits grew globally by 10% in 2022. Many investors forget that equities offer "real" protection, especially during periods of high inflation. As such, the market correction in 2022 has not been (or at least is not yet) a result of falling profits, but rather the fact that, due to their increased risk aversion, investors were willing to pay less than previously.

There are other plausible explanations and reasons for the corrections in equity indices. Firstly, high interest rates reduce the value of future cashflows. Secondly, numerous indicators point towards an impending cooling of the global economy. Both factors, coupled with the increased uncertainty and the war in Ukraine and other geopolitical tensions, have led to significantly lower equity prices. Further reductions in profit expectations must not be excluded, although the market had already priced in a pessimistic scenario during autumn. In addition, there has been a trend shift on equity markets away from technology stocks towards commodity, energy, financial and classic industrial stocks.

Selecting high quality companies remains at the core of our investment process. Companies with a leading market position and pricing power as well as higher profitability and earnings power – throughout the cycle – are better able to persist and develop their business in the current challenging environment. With rising interest rates, we have been focusing more on balance sheet quality and debt levels. Companies with no debt burden have more strategic options, and thus more sustainable.

Equity markets tend to anticipate developments in the real economy by six to twelve months. During a recession, whilst bad news is still coming in from the real economy, the equity market has often already moved out of the trough. As such, with an eye on the subsequent economic recovery, we can well imagine 2023 being a better year for equities than is currently being suggested by numerous market analysts.

Graph 3: Price-earnings ratio of equity indices*



Source: Bloomberg, Belvalor;
** Basis: monthly; profits: consensus estimates for the coming 12 months*

For this reason, we continue to invest in equities and select individual investments in accordance with our Belvalor quality criteria. We continue to recommend that only financial resources that can be invested over the long term and that will not be needed for some time be invested in equities. Despite short-term fluctuations, equities are still the most suitable instrument for ensuring long-term capital protection and growth.

Alternative investments

Energy has become more expensive. The shortages feared have not been entirely averted. Despite the recent fall-back in prices, we will still have to get used to higher prices. The price-restraining effects of a cooling economy are being offset by the expansion of renewable energy and a shortage of certain types of traditional energy sources.

Further upside potential might appear to be limited for **commodity** prices. However, demand is rising structurally, whilst supply is still scarce. Production, including mining, is not getting cheaper. This applies to energy and industrial metals alike, which alongside fossil fuels are an essential component of the energy transition and also indispensable as a bridging solution. Inflation protection has been making commodities more interesting, too. Companies from the oil & gas, commodity and mining sectors that have an ESG future strategy are attractive. Sustainability is taken increasingly seriously by them, and progress is becoming more apparent.

Precious metals in general, and **gold** in particular, provide suitable protection against inflation. As we are anticipating an extended phase of higher inflation, it is advisable to include gold in a balanced portfolio – in addition to offering inflation protection, it also makes sense from a hedging and diversification perspective. Equities of gold miners appear attractive to us. Cryptocurrencies do not feature in our investment policy. Following some upheaval, a more stringent regulation of the field is in the cards. We are monitoring developments and take the view that blockchain technology especially will change the world in future.

As a result of higher interest rates and the value adjustments applied to bonds and equities, competition to **private market investments** has emerged. Specifically, private debt investments can benefit from more flexible interest rate structures during times of rising interest rates. Taking account of substantial infrastructure budgets, the prospects for this type of investment are interesting. Due also to the reduced volatility, we are convinced that this investment class will be attractive over the longer term. Purchasing opportunities arise during difficult market phases for any buyer with a longer-term investment horizon. Alongside the equities of leading providers in the private equity sector, we are focusing on first-class investment vehicles that invest flexibly across various asset classes (private equity, private debt, real estate and infrastructure). We expect the weight and significance of private market investments to increase further.

Real estate prices have come under pressure as a result of higher interest rates. The location of a property remains the most important factor. Rental income will start to rise after a lag, leading then to higher returns. Over the short term, real estate equities and funds have become less attractive. After the impending healthy price correction, real estate will become more interesting again as a real asset.