BELVALOR
Vermögensbetreuung

Outlook 2024: Central banks remain key cornerstones

Inflation has peaked, but…

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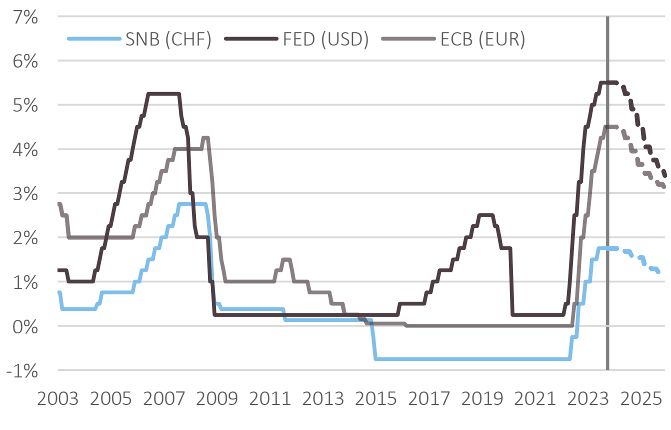
Central banks' tight monetary policy has had an impact. Inflation has peaked, with inflation rates falling considerably throughout the Western world. Central banks raised interest rates at the highest pace for decades. The effects of higher interest rates on the economy are not yet fully apparent, and in some cases will only be felt after a lag of several years. Partially, the impact is already evident in capital-intensive sectors such as real estate, but also on government budgets (with debt levels far too high). Higher interest rates will hold back economic growth. We are anticipating challenging economic conditions for the beginning of 2024. An economic recovery seems likely towards the end of 2024 and the course of 2025.

Although the US Federal Reserve (FED) and the European Central Bank (ECB) have been stressing their intention to keep interest rates high for an extended period, forecasters are broadly predicting interest rate cuts next year. The graph below shows historical levels of the key interest rates for the Swiss franc (CHF), the US dollar (USD) and the Euro (EUR) as well as consensus forecasts for the next 24 months.

Graph 1: Key interest rates in comparison



Source: Bloomberg, Belvalor

We also anticipate a further normalization of inflation figures in 2024. Nevertheless, the extent of interest rate cut speculation appears somewhat exaggerated to us. The still stubborn core inflation would have to fall back much more significantly than it did in 2023 and is restricting central banks' room for manoeuvre.

From a geopolitical perspective, the situation has deteriorated further in 2023. Hopes of an end to the war in Ukraine have been dashed, with the conflict morphing into an extended war of attrition. The situation has been complicated by recent developments in the Middle East. One can only hope that this conflict will not spill over into other countries in the region. Due to the focus on these conflict hotspots, Chinese provocations against Taiwan have receded into the background somewhat. The transition to a multi-polar world will result in an unpredictable future. The US presidential election in the autumn of 2024 will also be a source of tension.

What can investors expect in 2024? The end to the period of ultra-low or even negative interest rates has enabled investors to benefit from higher returns. We are expecting lower interest rates over the medium term, thanks to lower inflation and a weak economy. However, the process is expected to take longer than anticipated by many forecasters. Declining interest rates have a positive impact on assets such as equities and bonds. Equities remain the most attractive asset class. Inflation has hardly had any negative impact on corporate profits. Companies have successfully protected their profit margins through a mixture of price increases and productivity gains. Aside from a few single situations, equity markets are not overvalued. The USD is expected to weaken further, with the CHF remaining attractive over the long term.

There is a significant risk of a further economic downturn coupled with high inflation rates and additional geopolitical tensions. Financial markets could come under pressure in this scenario. We thus anticipate continuing stock market volatility, although reiterate our assessment from last year that 2024 could in the end turn out to be a rewarding year for investors.

Economic environment

The global economy proved to be astonishingly robust in 2023 and the consensus forecast of a widespread recession did not materialize. The economic development has been even more surprising if one considers the various challenges confronting the world. Numerous economies, particularly the US economy, have benefited from continuing high government spending and the attendant fiscal stimuli. Contrary to fears, economic growth was only supplanted by a downturn in a few countries. One of these was Germany, where largely domestic problems and ideologically driven policies laid the foundation for a recession.

In the midst of challenging economic framework conditions, companies were able to maintain profits at generally robust levels, although higher prices, well-stocked warehouses and waning demand gradually fed through into lower sales figures. The environment characterised by tight financing conditions and higher interest rates has so far particularly affected smaller and capital-intensive companies. Nevertheless, the impact of the altered environment will not become fully evident until several years have passed.

For now at least, the markets have been able to cope well with higher financing costs. There is a broadly established expectation that key interest rates will fall for the major currencies during the course of 2024. However, there is still plenty of uncertainty. Only time will tell how well the world will be able to deal with higher interest rates. There are currently signs of an industrial slowdown in both Europe and the USA. Currently, we do not know how long and how deep this “dip” will be. In our view, rising levels of government debt around the world and the related increase in debt servicing costs represent the greatest risks.

Innovation and technology provide the basis for future growth

The US economy proved to be resilient and grew more strongly than predicted by forecasters. Growth was attributable mainly to massive government spending, which in the end resulted in a substantial deficit. However, it is not certain how long the US will be able to carry on building up debts at this pace without any adverse consequences.

For a long time, the world economy has been able to rely on generous monetary and fiscal policies. Whenever the economic engine showed signs of stalling, central banks stepped in with interest rate cuts and asset purchasing programmes. However, money has now become scarcer and higher interest rates make it clear that this approach cannot be continued on an open-ended basis. Ideally, governments will get by in future without any assistance from central banks. Economies that implement structurally necessary changes will count amongst the winners in the long term. Switzerland is well positioned to be included in this group, as cautious fiscal policy has so far provided the foundation for positive economic growth and a strong CHF.

The graph below shows economic growth and inflation figures for the past year, along with consensus estimates for 2024. We usually approach forecasts with a certain reservation. At present we are quite optimistic due to the cautious consensus, and even see scope for positive surprises on the economic growth front over the coming year.

Graph 2: GDP and inflation 2023E and 2024E in %

	Gross Dom. Product (GDP)		Inflation	
	2023E	2024E	2023E	2024E
World	2.9	2.7	6.1	4.4
USA	2.4	1.2	4.1	2.7
Eurozone	0.5	0.6	5.5	2.5
Germany	-0.2	0.3	6.1	2.7
United Kingdom	0.5	0.4	7.4	3.1
Switzerland	0.8	1.1	2.2	1.6
Japan	1.7	0.9	3.2	2.2
China	5.2	4.5	0.4	1.5
Brazil	3.0	1.6	4.6	4.0

Source: Bloomberg, Belvalor

In structural terms economic progress is being propelled by population growth in both the USA and in Switzerland. The same consideration also applies for numerous Asian countries, except Japan and, to a growing extent, China. The progress achieved in the technology sector in recent years has had an increasing influence on companies and consumers. Agile and innovative companies that can adapt quickly and bring to market a variety of goods and services will benefit from these developments and provide the engine for future economic growth.

Currencies

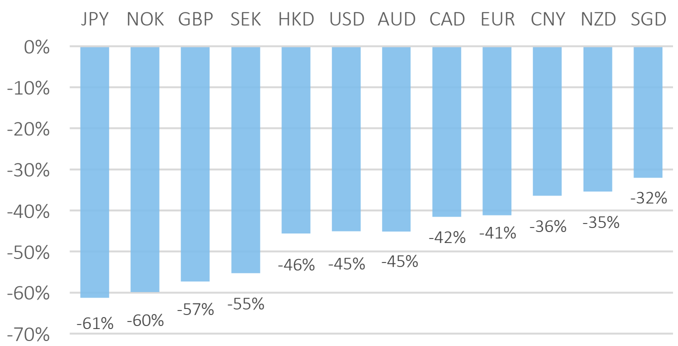
Following the sharp interest rate increases in 2022, most central banks in the major industrial countries continued to adjust interest rates upwards. With interest rates having reached a level that is widely expected not to be raised any further, the CHF has become even stronger and over the past year has climbed to record levels against many currencies, including the EUR.

Swiss Franc is still the most attractive currency over the long term

The USD is still overvalued on a purchasing power basis but has recently benefited from robust US economic growth and significantly positive real interest rates (nominal interest rates minus inflation). Since economic growth will slow down and interest rates are expected to be lower over the medium term, we are expecting the USD to weaken further. The rapidly growing government debt should also filter through into USD weakness. When weighted for purchasing power parity, the EUR is fairly valued for now against the CHF and could temporarily gain value in the event of a recovery in the European Economic Area. Over the long term however, the EUR will remain structurally weak.

We still expect the CHF to remain strong, reflecting the major competitiveness of our domestic economy, macroeconomic and political stability as well as high legal certainty. Moderate inflation and disciplined budget management (thanks to the debt brake) provide further reasons for CHF strength. We recommend minimising or hedging against foreign exchange risks, especially for investors who have the CHF as their home currency. As the graph below shows, the long-term increase in the value of the CHF, or conversely the depreciation in the value of many foreign currencies, has been substantial.

*Graph 3: Currency losses against CHF since 2000**



*Source: Bloomberg, Belvalor; * Loss in value of foreign currencies against CHF (01.01.2000 - 07.12.2023)*

Interest rates / bonds

Western central banks, including first and foremost the Fed and the ECB, raised interest rates further in 2023. The Swiss National Bank (SNB) also followed this trend. Low inflation in Switzerland has so far enabled the SNB to keep interest rates relatively low compared to the Fed and the ECB. Although inflation has fallen significantly in Europe and the USA, it is still however markedly higher than central banks' two-percent target. Core inflation in particular (i.e. aggregate inflation excluding food and energy) has only been moving hesitantly towards the target. It is therefore likely that central banks will stick to their tight monetary policy until inflation has fallen close to the 2% mark, or until the economy contracts more sharply.

Combatting inflation is (still) the number one priority of central banks

Because of the slowdown in growth, which is already apparent, we are not expecting any further interest rate increases in the major Western economies for the time being – quite the opposite. We anticipate that central banks could end their tight policy should any recessionary trends emerge or in the event of labour market stagnation. In such an event, central banks could also use other instruments alongside interest rate cuts, such as asset purchases or the injection of liquidity into financial markets. Although central banks have not signalled plans to drastically reduce interest rates in 2024, the markets have already priced sharp rate cuts for both the USD as well as the EUR. This scenario is supported by the positive real interest rates in the two monetary regions.

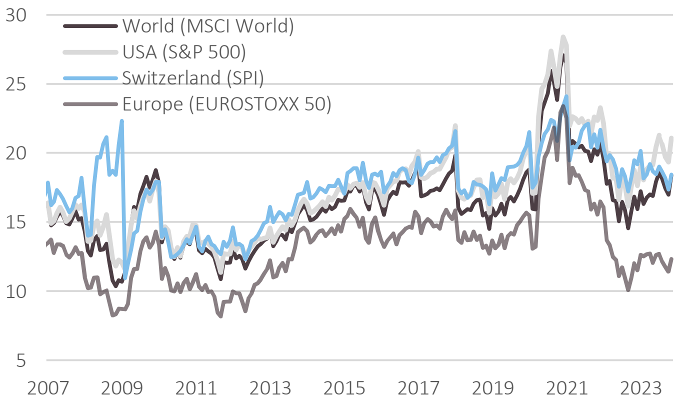
Following historic losses on the bond markets in 2022, the combination of positive real interest rates in some areas and a general decline in nominal interest rates represents an opportunity for investors. In a balanced portfolio, it makes sense to hold corporate bonds denominated in CHF, EUR and USD with maturities of up to five years. In addition, certain special segments such as cat bonds and high-yield bonds are still attractive as additions. Quality and liquidity remain core selection criteria for any investment in terms of risk/return considerations.

In the long term, we do not see inflationary pressures fully alleviated, in part due to the immense investment projects in infrastructure, structural energy shortages and especially due to the partially rapid increase in government debt.

Equities

Equity market valuations fell in 2022 on the back of rising profits and falling equity indices. This valuation correction has come to an end. In many regions, equity market valuations trend around the long-term average suggesting that, aside from a few individual companies, the market is not overvalued.

Graph 4: Price-earnings ratio of equity indices*



*Source: Bloomberg, Belvalor AG; * Basis: monthly; earnings: consensus estimates for the next 12 months (01.01.2007 – 30.11.2023)*

The economic and geopolitical uncertainties fundamentally favour the Swiss equity market, which not only has an overweighting of defensive companies but also is home to numerous high-quality firms. Broadly speaking, following a rather lukewarm 2023, the Swiss equity market has potential to recover over the coming year.

Preference for
Swiss quality
also in the equity market

As investors with a long-term focus, we are directing our attention to development trends in the technology sector. We are particularly interested by the various applications of new technologies that companies use to increase their efficiency, to cut costs and to meet challenges such as labour shortages. These technological advancements, including Artificial Intelligence, are becoming increasingly valuable resources for companies in various industries. As such, we are sticking to our tried-and-tested investment process and invest through the cycle in quality companies from various economic areas. Our most important quality criteria include structural market growth, a leading market position, a management with a proven track record, stable margins, a solid balance sheet and attractive returns on investments, along with a reasonable balance between using cash flows for investments and distributions. We are convinced that companies with these characteristics are ideally positioned not only to survive in the currently challenging environment, but also to develop their business further and gain market share.

Despite the current difficult geopolitical and monetary policy environment, equities are still attractive compared to other asset classes and remain our first choice. Although short-term fluctuations can occur, equities are the most suitable vehicle for protecting and growing capital over the long term. Expectations for the investment year 2024 are moderate in many places and there is potential for favourable surprises.

Alternative investments

Following strong cost increases during the previous year, **energy** prices mainly declined in 2023. The downward pressure exerted by a cooling economy led to falling energy costs, although abrupt, short-term price spikes can happen at any time, in particular due to the unstable geopolitical situation.

Price trends for **commodities** were generally mixed. Whereas demand for industrial metals remained low - not least due to the weak economic recovery in China - precious metals benefited from a combination of USD weakness, geopolitical uncertainty and the speculation that interest rates would be cut sometime soon. The price of an ounce of gold in USD has recently been trending at new all-time highs, thus exceeding the previous peak reached in 2020.

Gold shines
despite higher interest rates

Gold remains a recommended addition to a well-balanced portfolio, serving both as a hedge and for diversification purposes.

In our view **private market investments** remain interesting despite higher interest rates. We invest both in shares of leading private equity providers as well as directly in investment vehicles within various asset classes such as private equity, private debt, real estate and infrastructure. The relevance of private market investments, from our perspective, will remain significant.