



Market Outlook
4th Quarter 2023
Strong contrasts

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Economy

- A weakening of the global economy is expected, but with regional differences.
- The recent rise in energy prices will slow the decline in inflation.

Financial markets

- “Higher for longer” is the motto of the central banks in advanced economies. This is increasingly being priced in by the financial markets.
- Valuations of risk assets, especially in the US market, are rich and fully price in the current economic risks.
- In Europe, the competitiveness of industrial companies is likely to come under increasing pressure.

Risks

- A sharp slowdown in China poses a risk to global economic growth. Countries such as Australia, South Korea and Chile are particularly exposed, but growth in Europe is also likely to suffer.

World economy: Clouds on the horizon

The global economy has held up well overall. This is even though financing costs are at multi-year highs and high inflation rates are weakening purchasing power. However, there are strong regional and sectoral differences.

In the USA, private consumption remained surprisingly robust thanks to excess savings during the pandemic and a strong labour market, among other things. Service companies in particular benefited from this. In Europe, on the other hand, weaker demand from China, labour shortages and the continuing consequences of last year’s energy crisis are weighing on manufacturing, especially in Germany. Germany’s economy is expected to shrink by 0.3 per cent this year, while the US is expected to expand by 2.1 per cent.

The consequences of the restrictive monetary policy are likely to increasingly manifest themselves, also in the USA. A slowdown in global growth is therefore to be expected towards the end of the year.

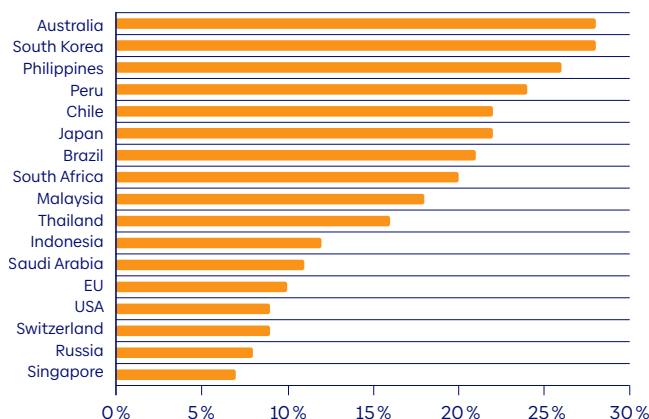
China’s reopening has been disappointing, and the government’s measures have not yet been able to stabilise the real estate market and the economy in general. China’s weakness therefore poses an additional risk to the global economy. Countries such as Australia, South Korea and Chile are particularly exposed. But Europe also has strong trade links with China. The People’s Republic is the third largest export destination for Swiss companies. Around 9 per cent of all Swiss exports found their way to China in 2021.

Inflation

Inflation rates have fallen sharply, but in many places, they are still far above the central banks’ targets. For example, inflation in the euro area has more than halved in the last twelve months but was still at 4.3 per cent in September.

Exports to China as a share of total exports

Situation in 2021



Sources: Baloise, UN Comtrade, World Bank as of 01.10.2023

The easing of supply bottlenecks and tighter monetary policy support lower inflation in the medium term. However, further declines are likely to be more uneven than has been the case in recent months. Two reasons speak for this:

- The recent rise in oil prices will slow the further decline in inflation. The price of Brent crude oil rose by 27 per cent in the last quarter and is thus around 8 per cent above the previous year’s level. This is mainly due to production cuts by Saudi Arabia and Russia. In Europe, natural gas prices also rose by 6 per cent in the third quarter. However, they are still around 76 per cent below the previous year’s level.
- In Switzerland, rising rents are likely to fuel inflation again in the meantime. The rent increases caused by the rise in the mortgage reference rate in June will be included in the inflation calculation in November.

Figures at a glance, in percent compared to previous year

		2022	2023	2024
Switzerland	GDP growth	2.7%	0.8%	1.3%
	Inflation*	2.8%	2.0%	1.4%
USA	GDP growth	1.9%	2.1%	0.9%
	Inflation**	4.9%	3.2%	2.3%
Eurozone	GDP growth	3.3%	0.5%	0.8%
	Inflation*	9.2%	3.4%	2.4%
China	GDP growth	3.0%	5.0%	4.5%
	Inflation*	1.8%	0.6%	1.8%

*Year-end value. **Measured at the consumption deflator.

Sources: Baloise, Bloomberg Finance L.P., as at 02.10.2023

Monetary policy: Higher for longer

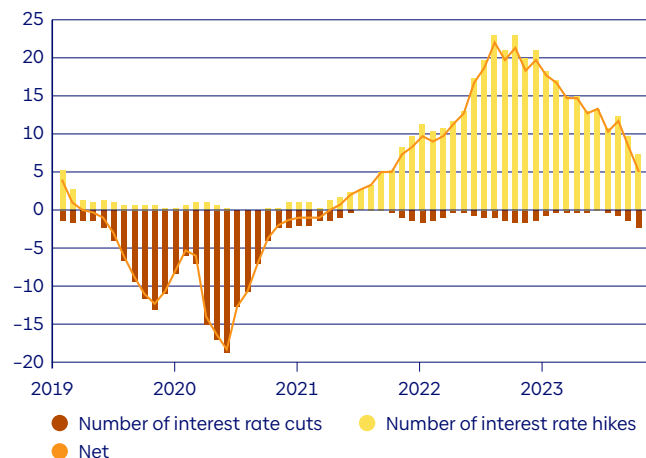
Analogous to the economic development, there are also regional differences in interest rate policy.

In advanced economies, interest rates have nearly peaked. However, it is still too early to talk about interest rate cuts because the mantra of the central banks in advanced economies is: “higher for longer”. This is supported by the surprisingly strong labour market figures, the spike in oil prices and inflation rates that are still well above target.

In contrast, some emerging markets already started cutting interest rates last quarter, such as the central banks of Brazil, Chile and Peru. Latin American central banks were also the first to raise rates when inflation shot up globally in 2021, months before the US Federal Reserve began tightening. Meanwhile, in China, monetary policy is being gradually eased to bolster the economy.

Global Central bank decisions

Three-month moving average



Sources: Baloise, BIS, as at 02.10.2023

The **US Federal Reserve** (Fed) raised its policy rate once last quarter by 25 basis points to a target range of 5.25 to 5.50 percent, a 22-year high. At its September meeting, the Fed signalled that another rate hike could follow by the end of the year. Amid robust economic data, the Fed considers rate cuts of 50 basis points in 2024 to be appropriate. In June, they were still forecasting an easing of 100 basis points. This reassessment led to a significant increase in long-term interest rates. The interest rate on 10-year US government bonds cracked the 4.5 per cent mark for the first time since 2007.

The **European Central Bank** (ECB) raised policy rates by another 25 basis points in September. The interest rate on the deposit facility reached an all-time high of 4 per cent. The interest rate on the main refinancing operation is 4.5 per cent. Market participants assume that the ECB has thus reached the end of its interest rate hikes.

In Switzerland, inflation has been back within the target range of the **Swiss National Bank** (SNB) since June. The SNB therefore decided to leave the key interest rate at 1.75 per cent at its last assessment in September, to the surprise of many analysts and market participants. However, the SNB stressed that the further course of inflation is uncertain and must be closely monitored. A further interest rate hike until the end of the year could therefore not be ruled out.

Credit: No further spread tightening

Review: After a long period of predominantly talking about the timing of the first interest rate cuts by central banks, the new narrative of “higher for longer” occupied the financial markets at the end of the third quarter. And with a view to the increasingly tense situation on the Chinese real estate market, the global macroeconomic conditions have tightened markedly in recent weeks. However, these more negative economic signs have not yet resulted in a significant widening of credit spreads on corporate bonds.

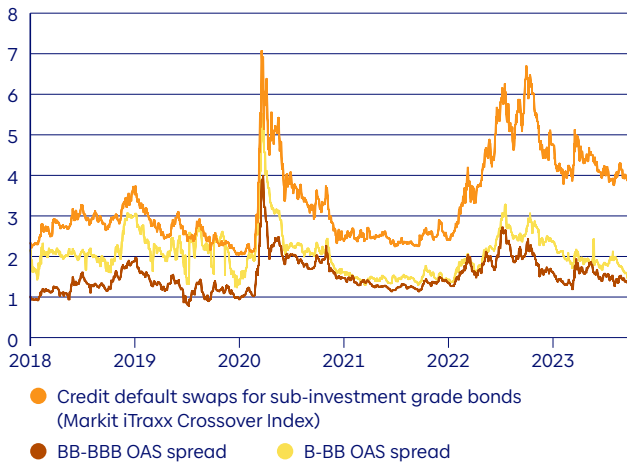
Thus, the credit spreads of BBB corporate bonds in US dollars are at 147 basis points (bp) at the end of September at a level slightly below the average value of the last 5 years. EUR BBB corporate bonds, at 178 bp at the end of the quarter, are 26 bp above the 5-year average. In the Eurozone, real estate companies in particular are facing higher premiums.

What is striking in the current environment is that the spread difference between BB-rated non-investment grade bonds and better-rated BBB corporate bonds is at a relatively low level, while credit default swaps for non-investment grade bonds have remained comparatively

expensive (see chart). Investors therefore currently tend to be insufficiently compensated for the additional risk of lower credit quality, especially when global economic risks are considered.

EU: Corporate bonds

in percentage points; % for cds



Sources: Baloise, Bloomberg Finance L.P., as at 02.10.2023

Outlook: Against the backdrop of the new “higher for longer” narrative, companies worldwide will have to adjust to high refinancing costs in the future as well. Companies with low margins and high refinancing needs in the next two years are particularly exposed to this development.

We are avoiding bonds issued by real estate companies in the euro area in the current environment. The increased refinancing costs will have a negative impact on earnings in the medium term. In this context, it can be assumed that real estate companies will lend more on their properties. Investors in classic unsecured bonds will therefore face greater structural subordination.

Caution is also called for among industrial companies, which are having increasing difficulties in maintaining their competitiveness due to the rise in energy prices and the European economic situation. This is already partly visible in Germany.

Given the risks mentioned, we see the current credit spreads as somewhat expensive, especially for bonds in Swiss francs and US dollars. We do not expect spreads to narrow further by the end of the year.

Shares: Adjusting to the new regime

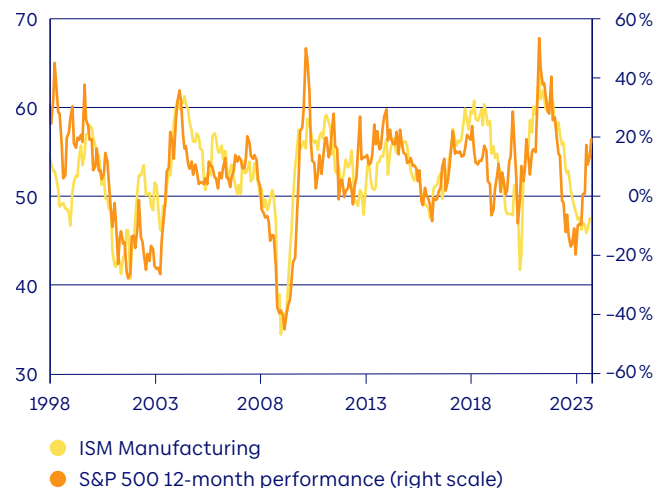
Review: The third quarter saw price declines on most stock exchanges. These largely reflect the reality of rising interest rates and increased economic risks. The global stock

market, measured by the MSCI All Country World Index, lost almost 4 percent. The emerging markets and the euro area in particular were negative.

There were big differences among the sectors. Real estate and utilities lost the most value. But the global technology sector also fell by over 6 per cent in the face of rising interest rates. The big winner of the quarter was the global energy sector which rose by over 10 per cent.

Despite declines in the last three months, most stock markets still show a strong performance on a year-to-date basis. The S&P 500 has risen by more than 11 percent since the beginning of the year. The Euro Stoxx 50 is slightly behind with around 10 per cent. Only emerging market stocks, burdened by the uncertainty surrounding China and the stronger US dollar, were down just 0.4 per cent at the end of Q3.

US equities: Pricing in soft landing



Sources: Baloise, Bloomberg Finance L.P., as at 02.10.2023

Outlook: The VIX index, also known as Wall Street’s fear barometer, rose significantly at the end of September. We expect this trend to continue in the final months of the stock market year, albeit to varying degrees depending on the sector and region.

In the USA, the political risk of a government shutdown was averted at the last minute. However, the risk of an unexpectedly sharp economic slowdown remains. Investors are pricing in only a slight weakening of the US economy, a so-called “soft landing” (see chart). This holds the potential for disappointment in the event of weaker macro data or even higher interest rates. Together with rich valuations, this currently makes US equities an unattractive asset class.

For emerging market equities, the further development of the real estate crisis in China plays a central role. Chinese equities account for around 30 percent of the MSCI Emerging Markets Index. We assume that the government in Beijing will take sufficient measures to achieve its GDP growth target of 5 percent. However, we do not expect comprehensive stimulus packages that could strongly boost local equity markets.

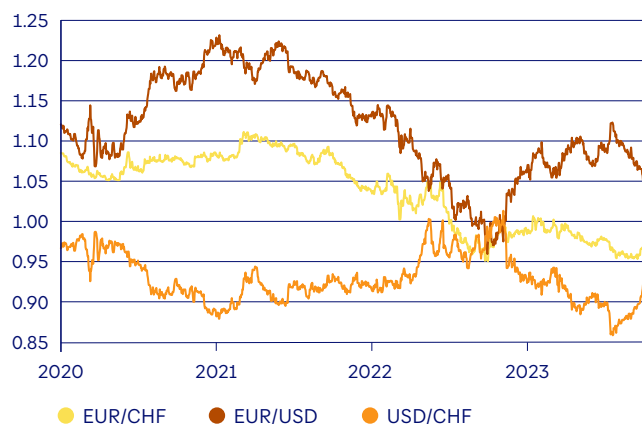
The European equity market is currently attractive from a valuation perspective for long-term investors. However, in Europe, manufacturers with low margins and a dependence on international trade are the most affected by the current economic situation and therefore also carry an increased risk.

Currencies: Euro weakness

Review: The euro reached 1.12 against the US dollar in July, its highest level since March 2022. A clear trend reversal set in at the end of July and the euro lost more than 3 per cent against the US dollar in the third quarter. Disappointing economic data in the monetary union were the driving force behind this. These contrasted in particular with surprisingly strong US data.

The euro also lost value against the Swiss franc, reaching a low of CHF 0.953 in mid-September. The SNB's decision to leave the key interest rate unchanged at the end of September surprised market participants and led to a depreciation of the Swiss franc against the euro. At the end of the quarter, one euro was quoted at 0.9676 Swiss francs. This corresponds to a devaluation of the euro by 1 per cent in the last three months.

Currency movements



Sources: Baloise, Bloomberg Finance L.P., as at 02.10.2023

Outlook: The economic environment does not favour the euro in the last quarter of the year. We expect a sideways movement against the Swiss franc, while there is still some depreciation potential vis-à-vis the US dollar.

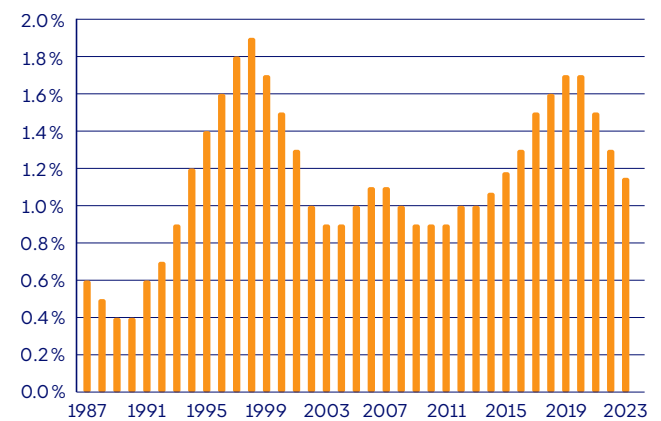
Since March of this year, the euro has been below parity with the Swiss franc. What was once a thorn in the SNB's side is now benefiting it in the fight against inflation because the strong franc is dampening the inflation of imported goods. In August, prices for imported goods were 0.3 per cent below the previous year's level. The SNB still reserves the right to sell foreign currency if necessary. The SNB's foreign exchange holdings in mid-2023 have decreased by around 14% compared to the previous year.

Real Estate Switzerland

Review: The effect of the SNB's decision to leave the key interest rate at 1.75 per cent was marginal on listed Swiss real estate funds. The SXI Real Estate Funds Broad Total Return Index has settled at a level of around 440 points since July 2023. The only major deviation from this level occurred at the end of August and the beginning of September.

Switzerland: vacancy rate

Share of vacant homes in total housing stock



Sources: Baloise, Bloomberg Finance L.P., as at 02.10.2023

The previous interest rate increases and thus the higher average interest rates for mortgages have led to the reference interest rate being raised by 25 basis points from 1.25 per cent to 1.5 per cent by the Federal Housing Office in June 2023. Until the average rate exceeds 1.625 per cent, the reference interest rate will remain at 1.5 per cent for the time being. Most recently, the average interest rate was 1.59 per cent. A further increase in the reference interest rate in December is therefore very likely.

The rental housing market continues to be very robust. On the one hand, this is manifested in the continuing decline in the vacancy rate of the Federal Statistical Office. While the vacancy rate was still 1.72 percent in 2020, it has now fallen for the third time in a row and will be 1.15 percent in 2023. Compared to the last 40 years, however, this is not a particularly low vacancy rate. Before the real estate crisis of the 1990s, the vacancy rate was well below 0.8 per cent, and in numerous years between 2003 and 2013, values below one per cent were also observed.

On the other hand, the development of asking rents also suggests a robust rental housing market. According to the Homegate rent index, asking rents rose by 3.9% in August compared to the previous year, although there are significant regional differences and the city of Zurich is an outlier with an increase of 10.2%.

The reasons for the falling vacancy rates and rising supply rents can be found both on the demand side (steadily rising consumption of living space per person, immigration) and on the supply side (higher construction costs, higher financing costs, lengthy building permit processes).

Demand for office space remains intact. At the same time, new construction activity has been declining since the start of the Corona pandemic, according to Wüest Partner.

Outlook: Positive impulses can continue to be expected from an income perspective. On the one hand, the next reference interest rate increase will most likely be communicated at the beginning of December 2023 and further reference interest rate steps could follow in the next few years. Furthermore, it will not be possible to expand the supply of residential space in the short term, which is why excess demand in the residential segment can also be expected in the near future, assuming immigration remains around current levels.

The office space market is likely to cool down again somewhat in the coming months. This is a consequence of the reduced economic growth and the associated reduced employment growth.

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