Review & Outlook
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Hyposwiss Advisors SA

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Q3-2023 Review

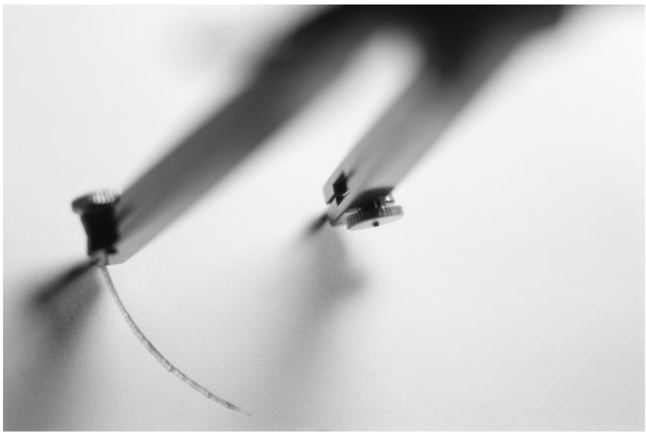
Bond markets took center stage during the third quarter of 2023. Over this period, 10-year yields in the US moved up by 0.80 points to 4.60%. The totality of the move originated from higher real yields, and there has been no change in long term inflation expectations. The move is remarkable not only in its magnitude, but also because it occurred in the context of broadly unchanged expectations for US monetary policy.

MSCI World Local Currency, 30.09.2021 – 30.09.2023
Source: FIS Market Map

Higher yield environment

This higher yield environment can in our view be explained by the following factors:

- Financial markets found it difficult to sustain an extreme yield curve inversion considering the continued resilience of economic data. In a sense, the "higher for longer" message hammered by central banks finally convinced markets.
- The supply/demand imbalance (at lower yields) for bonds led to a readjustment. A large component of the US deficit (which currently stands at 7.5% of GDP) is now structural, and some buyers of US debt are showing less appetite for this asset class (US banks, foreign reserve managers).
- The process of balance sheet normalization on which the Federal Reserve has embarked is not helping matters. The reduction of the size of the balance sheet implies a progressive need to find new buyers for the bonds that had been until then purchased by the central bank.



The increase in bond yields is at the core of explaining asset market returns for Q3 2023:

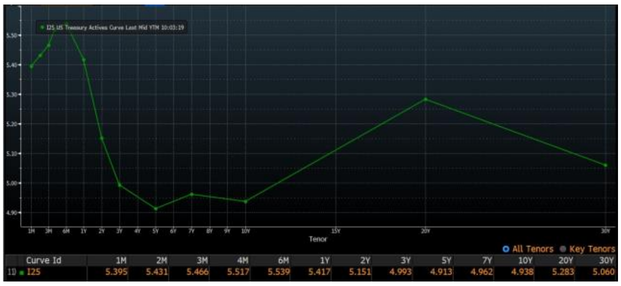
- In equities markets, the MSCI World Index ended the quarter with a loss of 3.36%. The US index (S&P 500) declined by 3.27%. This still leaves both indices comfortably up for the year (+7.1% for world equities and +13.1% for US equities). Emerging market equities are lagging with a return of only 1.8% year to date.
- On a sectoral basis, information technology (+33.8%) and consumer discretionary (+25.7%) are leading for the year by a wide margin. Among underperformers, health care and consumer staples are both down more than 5%.
- Returns from sovereign/high grade bonds are now negative to flat (US Treasuries are returning -1.5% and Investment Grade Corporates are flat year to date).
- High yield credit performed better (5.9%) as this asset class benefitted from the strong economy and has not yet been impacted by rising defaults.
- On the currencies side, the USD logically rallied during the quarter, benefitting for higher bond yields. It is now up more than 4% for the year on a trade weighted basis.

Central banks' land

In central banks' land, the key developments are summarized below:

- The US Federal Reserve increased rates by 0.25 points on its July 26 meeting, to a target range of 5.25% to 5.50% for Fed funds. This comes after a June meeting hold. It explained this move by the short statement that "inflation remains elevated", while acknowledging that "in determining the extent of additional policy firming that may be appropriate to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation". In implementing this forward guidance framework, The US Central Bank decided to leave rates unchanged at its Sep 19/20 meeting. Since that meeting, a chorus of Fed speakers referred to the tightening of financial conditions imposed by financial markets through higher bond rates and warned against the risk of overtightening. We find this chorus remarkable as it covered the full spectrum of Fed opinions (from dovish to hawkish members) and occurred against a backdrop of stronger than expected economic activity data releases.

- The European Central Bank hiked rates by 0.25 points at each of its July 27 and Sep 14 meetings, to a target of 4%. It acted to counter unacceptably high inflation, and despite recognizing the weakness in economic data. Most observer saw the September rate increase as a "dovish hike", as it was accompanied by a statement that indicated that policymakers see the new level of deposit rates as sufficiently restrictive to return inflation to its target over time.
- The Bank of Japan delivered a tweak in its policy on July 28 by making it more flexible, effectively moving the ceiling for 10-year bonds from 0.5% to 1%. Since then, JGB yields rose steadily but this has proved insufficient to stabilize the JPY. In public statement, BOJ officials that they are waiting for end of year indications on wage trends before considering further adjustments, notably removing the negative interest rates on cash.
- The Swiss National Bank surprised at its September meeting by leaving rates unchanged at 1.75%. It had stated explicitly its preference for tightening through the foreign exchange channel and stated in September that the significant tightening of monetary policy over recent quarters is countering remaining inflationary pressure. We view this as an acknowledgment of the better inflation performance in Switzerland and the effects CHF appreciation.



US Treasury yield curve as of 20.10.2023 Source: Bloomberg

On the economic side

- Overall activity in developed economies continuously surprised to the upside, led by the US. For the US economy, he effects of tighter monetary policy are lagging the historical cycle and are being countered by strong labor income as well as by pent up savings. Europe is seeing a more traditional relationship between monetary policy and economic activity, and the economy is slowing there. Chinese growth is disappointing expectations, with the associated global effects.

- The June Consumer Price Index (released in early July) finally indicated that the process of disinflation started. This has since been confirmed, with monthly core CPI releases oscillating between 0.2 and 0.3 over the quarter. It is likely that this favorable trend will, in due course, also permeate to other developed economies in varying degrees. Encouragingly, we note that overall inflation in emerging economies is slowing sharply, allowing many EM central banks to loosen policy rates.

Investment management

From an investment management standpoint:

- The portfolios under our supervision have been impacted by the unfavorable financials markets trends. This correction has been made more unpleasant by the fact that the negative sources of return originate from both fixed income and equities.
- In term of geographical allocation, our portfolios remain overweight in developed markets and are sharply underweight in China related assets. In terms of sectors, we maintain a well-diversified approach recognizing the significant valuation dispersion among financial assets.

Looking forward, in adopting a 6/18-months investment horizon, we can make the following statements:

- The large rise in bond yields that occurred during the quarter is a serious tightening of financial conditions. It will therefore, if maintained, contribute to reduce economic activity over the coming quarters. The Federal Reserve has explicitly taken note of this, and as such this rise in yields reduces the likelihood of immediate further tightening through short term rates.
- The disinflationary process under way has been confirmed by economic data. At some point it will allow the Federal Reserve to consider reducing rates form current restrictive levels.
- Long term yields for government bonds or high-grade corporate bonds close to (or above) the current level of Fed funds are therefore offering a very favorable risk/reward on a 12 months horizon.
- Corporate profits in the US are likely to bottom in Q3 2023 and can grow modestly thereafter.

The above environment leads us to follow the following guidelines in investment policy:

- The fixed income portion has been increased. It is geared towards achieving a positive carry versus cash yield levels with a reasonable risk. For the first time in many years, we can see value in the longer end of the curve and in inflation-linked securities (at a real yield of 2.5% for 10-year Treasuries). We also are at the stage of the cycle where we pay particular attention to the credit quality of the portfolio and concentrate holdings in the investment grade and BB segments of the market.
- For equities, the environment of disinflation and steadily growing profits will be broadly supportive. The increase in yields is compressing the risk premium and affecting the valuation of the overall asset class. Therefore, we advise to concentrate holdings in the highest quality segment of equity markets.

At the time of writing, the tragic events in the Middle East are unfolding. We are mindful of the possible market implications, and our heart and prayers go to all those affected.

Daniel Jakobovits
Head of Investments

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- Hyposwiss Advisors' mission is to offer **personalized asset management services and financial advice** to high-net-worth individuals and families based in the **USA** and **Canada** with the overriding objective of **capital preservation** and **asset growth** performance oriented.

- Investments in compliant global assets are used to construct a **diversified balanced portfolio** tailored to the investor's requirements and deposited with **international banks** acting as qualified custodians.

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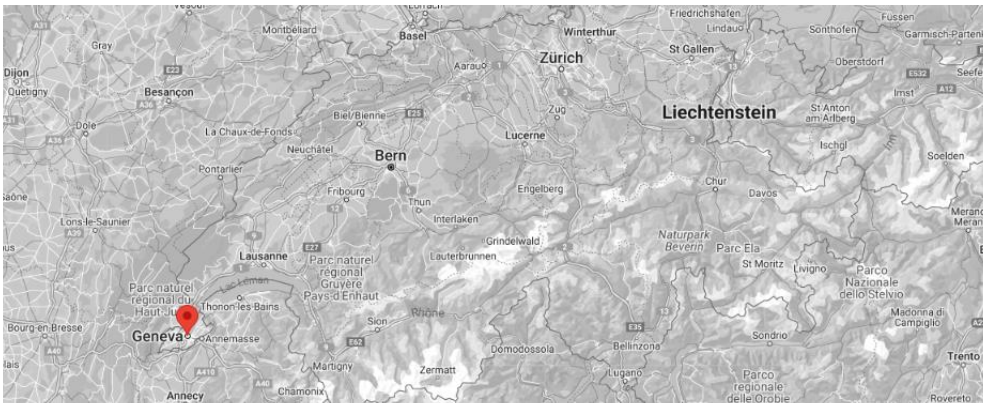

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