Executive Summary

- Even though peak US inflation is likely behind us, the FED will not stop tightening monetary policy until inflation is going down significantly. Powell made that clear in his speech at the Jackson Hole Economic Symposium, thereby ending premature speculation about an early dovish pivot and, thus, putting the bear market rally on hold.
- Compared to the US, the economic situation in Europe and China is poor. Recession risks in Europe are growing as escalating energy prices cripple the continent. China will miss growth targets by a wide margin as stimulus measures cannot outweigh the Zero-COVID policy and the battered property sector.
- In our base case, the bear market continues. However, since the probability of a soft landing in the US has increased and the June lows may hold, we slightly adjusted our defensive positioning.

The end of the bear market rally

The powerful bear market rally continued into August, at one point retracing even more than half of the drawdown since the market top. Speculation of a dovish pivot in monetary policy by the FED and macroeconomic data supporting a softish landing drove this spike. Yet the S&P 500 failed to surpass the critical 200-day moving average and Powell's hawkish speech at Jackson Hole ultimately ended the rally.

Market Development

World

- It seems that inflation in the US has finally peaked. Year-over-year CPI came in at 8.5% in July vs. 9.1% in June. The PCE deflator, the FED's preferred price gauge, mirrored this development, declining to 6.3% from 6.8%. Lower gasoline prices were a big detractor.
- Sales of new homes in the US fell at their slowest pace since early 2016, extending a months-long deterioration fueled by high mortgage rates. Rising stocks will likely put downward pressure on home prices in the months ahead.
- Despite new stimulus measures (lower loan prime rates and 1 trillion Yuan for additional infrastructure spending), China will miss its 2022 growth target of 5.5% by a wide margin according to economists, who are only expecting growth of 3.5%.

Europe

- As power prices reached previously inconceivable levels, the EU is preparing emergency measures to curb the price of electricity by separating it from the cost of gas.
- Some European utilities, such as Germany's Uniper or Austria's Wien Energie, require billions in government support to keep operations running.
- The Euro is trading at parity against the US Dollar – the last time this happened was in 2003.

Switzerland

- Swiss businesses and households are also affected by the energy crisis, but not to the same extent as in the Eurozone. The strong Swiss Franc is cushioning the shock.
- The SNB is expected to increase interest rates again by 50 basis points to 0.25% and complaisantly accept any appreciation of the Franc.

Powell rejects an early dovish pivot

Powell's speech at the Jackson Hole Economic Symposium was very clear and concise, thereby correcting the dovish interpretation of the last FOMC press conference. The US central bank is determined to get back to 2% inflation and "must keep at it until the job is done". Pivoting too early is a risk that policymakers do not want to take, as it could lead to inflation becoming entrenched in wage and price setting, something that happened in the 1970s/80s, and which would be difficult to reverse. Even though he did not say anything new compared to what other FOMC members had said in the days before, the market listened to him and started to dial back on rate cut bets for 2023. At some point, when inflation comes down convincingly and/or the economy slows materially, then the FED will eventually pivot, but at this stage it is premature to come to such a conclusion yet.

Our base case is that we are still in a bear market. As explained in the last market view, it would be unusual if we had already seen the low in June. We formulated two conditions for a bottom, neither of which has been met. First, a sustainable shift in monetary policy. Powell's speech at Jackson Hole made clear that we are not there yet. Second, a repricing of growth expectations, meaning that predicted earnings growth should be revised down significantly as the global economy is certainly slowing down, and maybe even entering a "real" recession. This has not happened either. For example, the S&P500 next twelve-month EPS growth has only been revised down slightly by about 2%.

Nevertheless, we acknowledge that the probability of a soft landing has increased. US inflation peaked and could potentially come down quickly without a strong economic deterioration. Somewhat unintuitively, economic data from July pointed to lower inflation and stronger economic growth than expected. Some technical indicators, such as the extent of the retracement or the broad participation in the rally, support the view from a historical perspective that we might already have seen the bottom.

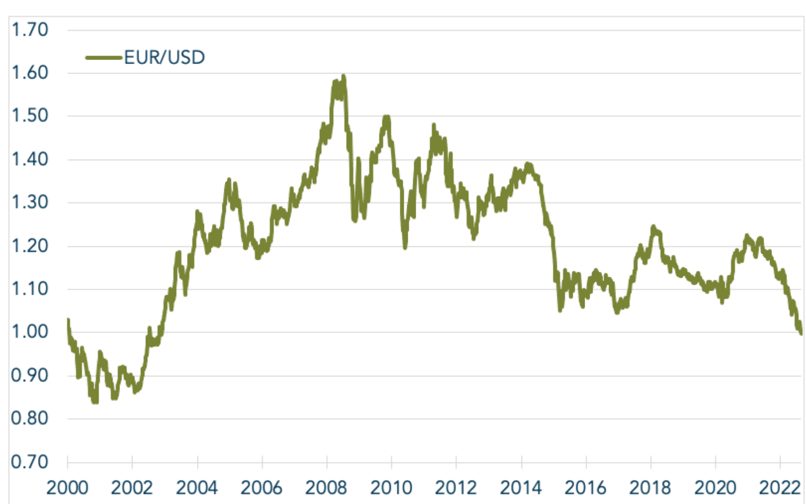
Positioning

- The macro environment continues to be challenging for risk assets. Preserving capital remains vital and risk management still has the highest priority. We are therefore continuing to underweight equities and credit, and overweight cash, gold and alternatives.
- Although not our base case, incoming data has increased the probability of a soft landing. To incorporate this change in our portfolios, we have slightly decreased our underweight in equities.
- In addition, we also added another limit to our plan to gradually increase our equity exposure at pre-defined levels at which the overall market would be attractively valued. Our first limit was reached in June's trough. The new limit has been placed a bit higher, in case the low holds. The next limits for the S&P 500 still lie in the range of 3550–3350. Our equity allocation would change to neutral if all three limits were executed.
- Within equities, we favor quality-growth stocks because we expect them to outperform on a relative basis if the bear market continues, but also if the recent soft landing narrative continues.

Chart

Pressured by the energy crisis, fragmentation risks and the widening interest rate differential, the Euro depreciated heavily against the US Dollar and is trading at parity, a level last seen in 2003. The overarching downtrend that began with the financial crisis in 2008 underscores the structural problems of the currency and points to further weakness.

Euro at a 19-year low against the US Dollar



Source: Bloomberg

Sources: Bloomberg, Financial Times

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