Zuger Kantonalbank

Portfolio – Update

7 August 2024

The leading economic indicators are painting both a light and dark picture. The US central bank (Fed) is sitting on its hands for now and has confirmed its existing pathway of restrictive monetary policy. This constellation is weighing on equities. US technology stocks are leading the global equities sell-off. Government bonds are appreciating strongly. Our basis scenario remains unchanged.

Economic developments and the Fed provide the trigger

As expected by the market, the Fed refrained from cutting interest rates at its meeting in July 2024, and instead maintained its hawkish stance. In the two days that followed, the leading indicators for the manufacturing sector and the US jobs report pointed to a slowdown in the economy and the labour market respectively. Fears rapidly spread among market participants that the Fed would act too late – just as it did when inflation took off. The consequence of this would be a "hard landing" of the economy, in other words a recession in the United States.

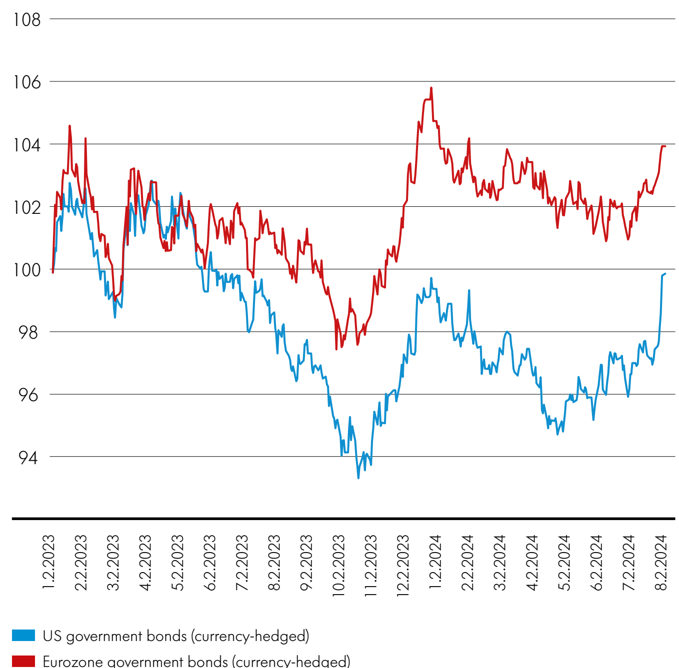
BOJ raises key interest rate

This situation was further exacerbated by the decision of the Japanese central bank (BOJ) to increase its key interest rate from 0.1% to 0.25%. This move was accompanied by a very hawkish commentary, which duly caused the yen to appreciate. For many years, the Japanese yen has been used as a financing currency due to Japan's very low interest rates in a global comparison. Investors would take on debt in yen and invest the capital globally in higher-yielding bonds or equities. The rise in Japan's key interest rate prompted investors to unwind these positions, thereby strengthening the downward pressure on stock markets.

Mixed portfolios offer protection

These events brought about a veritable flight from equities to safe havens. At a stroke, the money markets priced in three additional interest rate cuts in the US. The government bonds of developed economies as well as bonds denominated in Swiss francs were suddenly the object of heavy demand, leading to a decline in market interest rates and therefore to rises in bond prices (bond prices and bond yields having an inverse relationship). These events have highlighted the diversification and hedging function of bonds in mixed portfolios (see chart). As an additional factor, their coupons provide attractive ongoing income streams. These have partially cushioned some of the losses from the equity market sell-off.

Price development of currency-hedged government bonds



US equity market undergoes correction

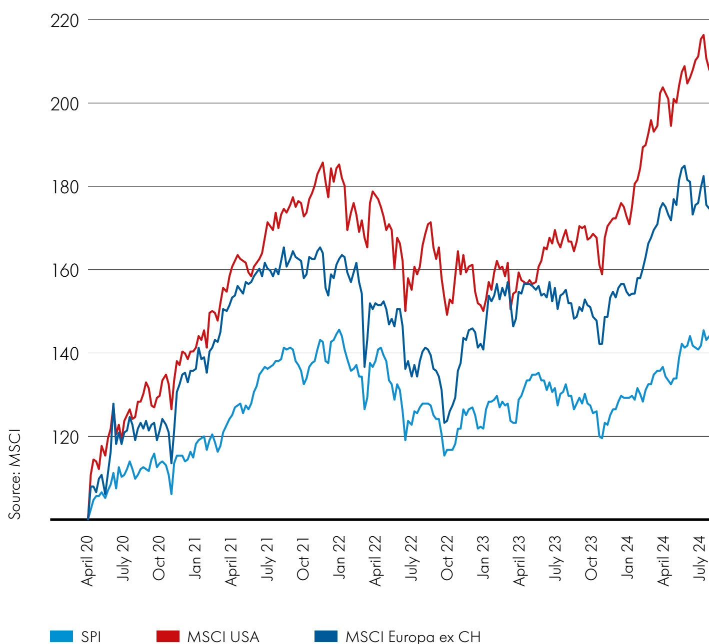
Growth stocks in the US – and semiconductor stocks in particular – have experienced sharp corrections in recent days. In addition to the factors cited above, the

seasonal weak phase has further fuelled the consolidation process. Poor figures unveiled by Intel, general fears of an intensification of the US-China trade war, and the aforementioned weakness in the US macro picture have all weighed on equity prices. The fear that the Fed might be lagging behind real economic developments with its rate cuts has greatly depressed equity market sentiment.

Technology a prop

Our view continues to be that AI as an investment theme has a substantial presence. This assessment is confirmed by the results of the major cloud providers such as Microsoft, Alphabet, Amazon and Meta, all of which have met the market's high expectations. The most recent quarterly results of these technology giants have further confirmed the significant sums being invested in infrastructure and data centres. The sums in question will actually increase next year and therefore remain the key driver of developments in this sector. Future earnings estimates for the US equity market are pointing strongly upwards, and are not pricing in any US recession. The relative appeal of the US market is underscored by both short-term and long-term return developments (see chart). In our mixed mandates we also invest in the broader equity market in the US, with no excessive focus on technology stocks.

Equity market performance since 2020



Swiss equities rocked by global storms

European and Swiss equities have likewise suffered a correction in the wake of US stock market weakness. The worst hit were the large caps that had performed strongly over the year to date and were therefore subject to profit-taking, but equities from the semiconductor sector such as VAT also suffered. This said, we are confident with regard to the remainder of the year. The reporting season of Swiss companies was better than investors had feared. Even if sales growth proved sluggish in some cases, many companies were able to unveil strong earnings. For the most part, the business outlooks for the second half of the year were positive too. Many companies are anticipating an improvement in the economic situation in the second half of the year, which should result in higher profits and therefore support equity prices.

Basis scenario remains unchanged

In the midst of this equity market storm, the figures released on the business activities of the US services sector this week had a soothing effect. The corresponding index returned to the growth zone, alleviating fears about the strength of the US economy. This data development confirms our basic assumption, namely that the US economy will weaken only gradually. The risks to our basis scenario remain the same: an unexpected acceleration of the economic slowdown and an escalation of the situation in the Middle East.

What does this mean for investors?

Irrespective of recent developments, bonds continue to offer attractive yields and price appreciation potential. We are expecting the global rate-cutting cycle that is already underway to continue. The Fed too will start to cut rates sooner or later. Given our economic and inflation expectations, capital market interest rates should likewise decline further in the second half of 2024. This is an argument for maintaining a broadly diversified portfolio in which bonds play an important role. Equity market developments can be expected to remain volatile over the coming weeks and months, with investors keeping their eyes firmly fixed on monetary policy and the development of the economy.

We recommend that investors remain true to their personal investment strategy and existing orientation. In this crisis too, investors would do well to act with circumspection, realigning their portfolios with the changed situation on a step-by-step basis where necessary.

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