Vontobel

Investors' Outlook

China out of favor with emerging-market investors? No, but …

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China out of favor with emerging-market investors? No, but …

Dear readers,

The sell-off in Chinese equities after the recent communist party congress in Beijing has been a stark reminder that so-called "country risks" can be high when investing in emerging markets (EM). It's true that everybody pretty much knew that Xi Jinping would be handed a third term as president. But what took the market by surprise was the bold confirmation of China's zero tolerance towards the Covid-19 pandemic, dashing hopes for an easing of restrictions. Likewise, investors looking for an announcement of economic stimulus measures were disappointed. Add to that the very public escorting from the main stage of a former leader, Hu Jintao, who appeared to resist removal. It amounted to a dramatic display of power being consolidated, raising questions about top-level governance issues.

While strict pandemic-related lockdowns across the country continue to weigh on the economy, the situation is made worse by structural problems that refuse to go away. Double-digit youth unemployment rates, a rapidly ageing population and a property market that is supported by highly indebted Chinese real-estate companies all pose significant challenges. Deglobalisation and the recent efforts of the United States to restrict the supply of semiconductors to China are further points of concern.

—
Dan Scott
Head of Vontobel Multi Asset,
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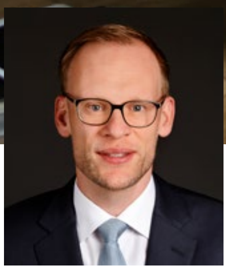
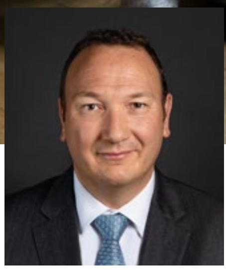
The emerging markets are where nearly two thirds of the world's population live—they can't be ignored. But many investors have begun to direct their gaze at lower-profile countries that have been eclipsed by the world's second-largest economy so far ("EM ex-China"). Currently, a group formerly known as "the fragile five" might well provide the best opportunity. Please have a look at our focus article in this edition for the details.

We will continue to follow emerging markets including China closely. At the time of writing, there is speculation in the press that China may now consider an easing of lockdown policies. Meanwhile, as with all investments, the final decision on where and when we invest is the result of whether the estimated return potential can compensate us for the risk taken.

→ **Webcast**
To view our webcast on recent market developments, click **here**





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Sometimes, sitting tight is best—all views confirmed

Perhaps counter-intuitively, active investors can be perfectly happy pausing. In hectic times like these, keeping one's cool amid a market downturn is wise, we believe. A poised yogi contemplating a puffing jogger might feel the same.

If pausing for thought suggests inaction, it shouldn't. Since our previous monthly investment committee meeting, we have had ample opportunity to question the slight equity overweight stance announced a month ago. We decided to keep it with high conviction despite a rising likelihood of a recession and the resolve of major central banks to fight inflation (rightly so) via higher key rates.

Several factors support a continued positioning in equities, in our opinion. Stocks, long out of favor due to negative inflation news, tightening central banks, and concerns about Russia's invasion of Ukraine, have rebounded. More interestingly, the fundamentals that drive the market are not so bad. With inflation peaking, consumer price indices will stabilize and eventually decline. At the same time, a worsening job market, particularly in the US, presents central banks with a good excuse to become more accommodating again in 2023. Emerging-market equities remain under pressure, but we downgraded that segment a month ago.

Bonds, rated neutral overall, have been hammered this year. Some segments retain their risk-mitigating quality and even offer some return. The same may hold true for emerging-market bonds in hard currencies, where prices appear to have hit rock bottom. Details of our positioning can be found on the overview page 5 or the asset class-focused items on pages 12 to 15.

	UNDERWEIGHT significantly	UNDERWEIGHT slightly	NEUTRAL	OVERWEIGHT slightly	OVERWEIGHT significantly	
1 Liquidity		→				A month ago, we used part of our cash to increase our equity position. The slight underweight on liquidity that resulted from that change remains in place.
2 Bonds			→			Our longstanding neutral view on fixed income is confirmed. Bond bulls had nowhere to hide this year given what appears to be the worst drawdown ever, mainly due to central bank moves to tame inflation through rate hikes. Next year, they may pause on their way up or even start moving interest rates lower. Therefore, yields look set to fall over the next 12 months, especially on bonds with shorter maturities. A degree of duration, i.e., a certain amount of bonds with longer maturities, seems appropriate, which suggests an overweight in sovereigns. Investment-grade corporate bonds remain on neutral and high-yield paper on underweight. Yields in the emerging market hard-currency space appear relatively attractive.
3 Equities				→		Our recent slight overweight signals our confidence regarding equities, reflecting expectations that the US Federal Reserve will change course early next year due to a darkening economic outlook. In terms of subsegments, we continue to prefer US and Swiss stocks. Both markets usually outperform when global growth comes down, and the companies tend to display a higher resilience when it comes to profit margins as well as return on equity compared with those in other regions. We also maintain our neutral view on European and Japanese stocks after last month's upgrade. In hindsight, this was a timely move. We believe the European market offers prospects for long-term investors, even after adjusting earnings estimates for an increased likelihood of recession. Some stocks seem attractively priced versus US equities, but it's worth remembering that the European market is no longer the same as in 2008, for instance. Since then, the weight of the financial sector decreased from 30% to less than 12% and that of consumer-related sectors, such as discretionary or staples, more than doubled to above 30%, partly thanks to luxury. For Japan, the weak yen should benefit exports, a development likely to boost the corporate sector's robustness should the economy slow down. We also feel comfortable with our recent downgrade of emerging-markets stocks to negative.
4 Gold				→		We keep our gold overweight despite the US Fed's hawkish stance and the ensuing headwinds for the yellow metal this year. We believe that gold should regain strength once the US monetary authority turns less restrictive. On top of that, we also like gold as a hedge against geopolitical risks and sudden bouts of inflationary pressure.
5 Commodities			→			Our neutral rating on commodities remains in place. We believe in the longer-term appeal of the asset class owing to, for example, years of underinvestment in production capacity and the push towards a "greener" economy, which will benefit some commodity segments. However, the asset class may suffer when economic growth retrenches.
6 Alternative strategies			→			We retain our neutral view on alternative investments overall, i.e., a modest underweight in hedge funds and neutral view on real estate.

Changes month-on-month: same → higher ↗ lower ↘

US labor market strong but jobs look set to go

—
Michaela Huber
Investment Strategist,
Vontobel

—
Stefan Eppenberger
Head of Multi Asset Strategy,
Vontobel

"Foreman says: these jobs are going, boys, and they ain't coming back", Bruce Springsteen sang in his 1985 hit *My hometown,* describing the human cost of a closed textile mill. Today, the employment situation in the US is fundamentally different, but the American bard's words still ring true. After a long ride in the sun, the job market is beginning to feel a cold breeze generated by the US Federal Reserve.

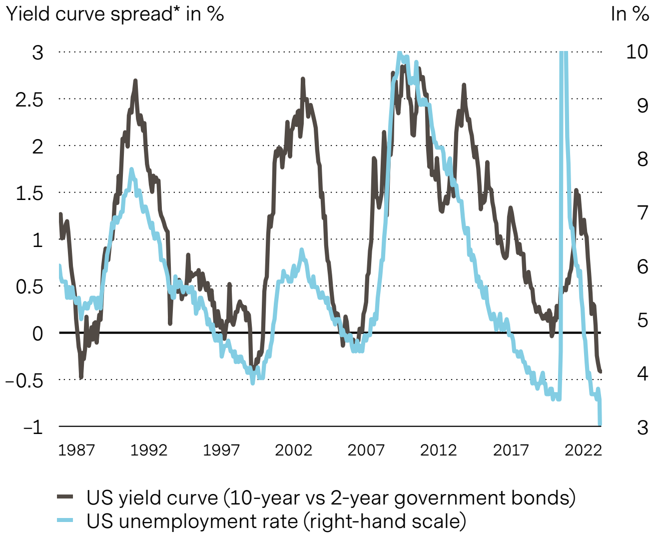
Over the past few months, one economic indicator after another lost momentum. The much-cited purchasing managers' indices plummeted below the critical 50-point line, various business surveys painted a gloomy picture, and consumer confidence suffered a severe setback.

The "last employee standing" will cave in

The only remaining bastion of strength was the US labor market. Churning out job ads, companies were hiring several hundred thousand new employees each month. The unemployment rate has been dropping steadily, hitting a 50-year low this summer (see chart 1). This didn't escape the attention of the US monetary authority. Meeting after meeting, Federal Reserve Chairman Jerome Powell pointed out that the "very, very strong" labor market allowed for an aggressive tightening of monetary policy to keep the economy from overheating.

According to recent US labor market data, the US Fed's rate hikes are now starting to be felt. Already in August, the number of job openings fell by more than one million, the sharpest drop since the start of the pandemic (see chart 2).

Chart 1: The presently very tight US labor market is a late-stage economic cycle phenomenon



* The higher the yield difference (spread), the lower the probability of recession. Negative readings mean short-term interest rates are above long-terms ones, which signals economic hardship.

Source: Refinitiv Datastream, Bureau of Labor Statistics, U. S. Department of Labor, This ties in with American consumers' more cautious view of their employment prospects, according to data compiled by research company The Conference Board. At the time of writing, the cooling of the labor market is not yet translating into significantly higher unemployment rates. However, we think this will change in the months ahead. Given the deteriorating macroeconomic backdrop, stubbornly high inflation, and tight monetary policy, a recession now looks like a done deal—and during a recession, unemployment typically rises by at least 1%, more often 2%. As a rule of thumb, this happens once companies' costs start reaching the level of revenues—and costs have been rising of late while gross domestic product growth has slowed down.

Drag on wages and consumption

What does this mean for wage growth? Commonly used leading indicators computed by the Atlanta Fed or the Dallas Fed suggest that wage pressure should decline (see chart 2). This should also affect consumer behavior—but it's worth noting that consumption is already under pressure due to high inflation. In our view, all this makes a so-called wage-price spiral of the kind that occurred in the 1970s rather unlikely.[1]

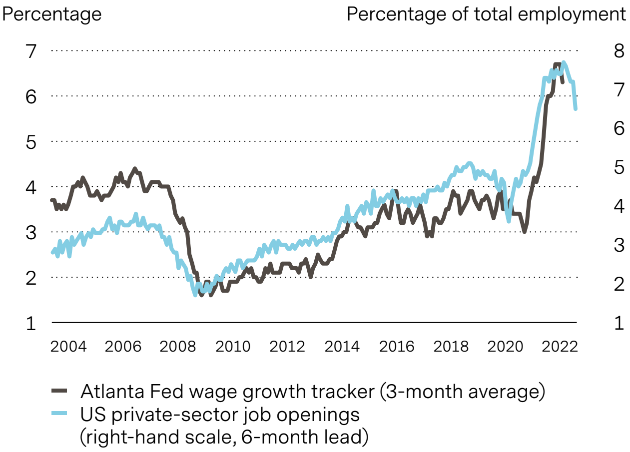
Some Fed hawks get dovish

Sooner or later, this should result in more supportive monetary policy. In the past, the US Federal Reserve always lowered interest rates at the latest when there was a significant increase in the unemployment rate (see chart 3). Apart from that, some Fed members recently used expressions like "peak hawkishness" in early 2023, meaning that the central bank could start loosening the monetary screws by that time. Moreover, Mary C. Daly, at the helm of the San Francisco Fed, noted that while rates may still rise, the time "is now to start talking about stepping down." To sum it up: higher unemployment lowers consumption and economic growth rates, puts pressure on wages and inflation, and eventually prompts the central bank to ease monetary policy.

What could keep unemployment in check?

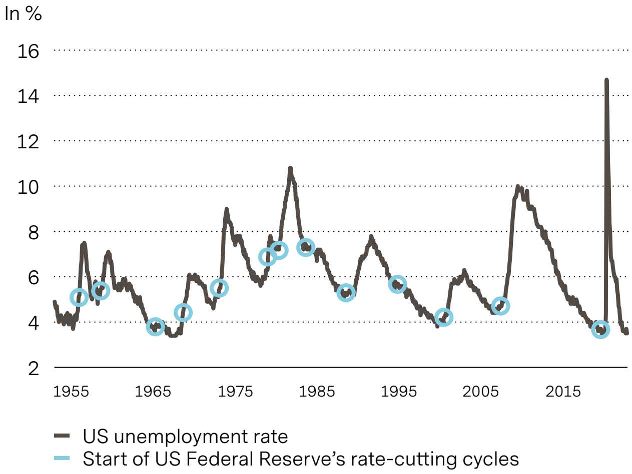
There are several key drivers that could keep unemployment structurally or cyclically lower. One of them is the labor force participation rate, which reflects the proportion of economically active persons in a reference population. The US labor force participation rate collapsed in early 2020 due to the pandemic. It hasn't recovered since, partly because a high number of older workers left the labor force without returning, for reasons such as this cohort's concerns about the pandemic, or health complications, or the use of personal wealth towards early retirement. On top of that, the rate is also affected by general demographic trends (as ageing "baby boomers" push down participation) and lower immigration (due to Covid-related entry bans, delays in processing visa applications, etc.). Another driver is the so-called Beveridge curve representing the relationship between unemployment rates and job opening rates. It is typically downward sloping, i.e., the vacancy rate decreases as the unemployment rate increases. The Fed, however, hopes that things will be different this time around: it seeks to bring down inflation via a lower number of job openings without facing the prospect of a significant rise in the unemployment rate. However, there's an issue: when companies need to defend shrinking profits, reducing the number of open positions doesn't save them any money—cutting existing jobs does. Therefore, the former will hardly happen without the latter occurring as well. Lastly, US unemployment could also be kept in check by increased deglobalization—consider the "re-shoring" of critical supply chains, which may boost demand for domestic labor.

Chart 2: Job openings declining sharply, in line with US Fed's endeavor—wages likely to follow



Source: Refinitiv Datastream, Atlanta Federal Reserve, Bureau of Labor Statistics, U.S. Department of Labor, Vontobel

Chart 3: Rising unemployment is a reliable trigger of rate-cutting cycles in the US



Source: Bureau of Labor Statistics, U.S. Department of Labor, Vontobel

[1] On top of that, US workers are also less well-organized today than in the 1970s. According to the U.S. Department of Labor, union membership has dropped from around 30% in 1970 to only 10% in 2021.

How “the fragile five” transformed into “the compelling quartet”

In 2001, Jim O’Neil, a Goldman Sachs economist at the time, coined the term BRICS, standing for the then fast-growing emerging economies of Brazil, Russia, India, China and, later, South Africa. However, such acronyms tend to lose relevance over time. Back in 2001, BRICS were the countries of the future. Today, only two of them (China and India) have a higher GDP per capita than ten years ago, while Brazil, Russia, and South Africa are at risk of remaining countries of the future for longer.

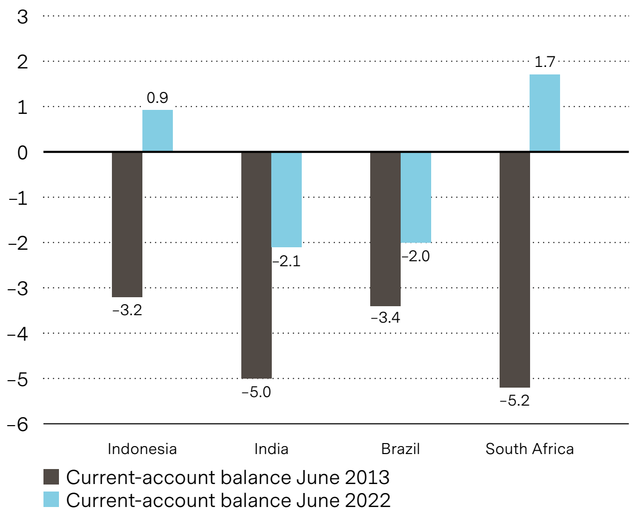
—
Thierry Larose
Portfolio Manager,
Fixed Income Analyst,
Vontobel

This brings us to the summer of 2013, when a Morgan Stanley analyst came up with “the fragile five”, referring to a set of five emblematic emerging countries (Brazil, India, Indonesia, South Africa, and Turkey). The group was supposedly suffering post the so-called taper tantrum, which started in May 2013 after the US Federal Reserve shocked the bond market by hinting about an imminent tapering of the third round of their asset purchasing program known as quantitative easing (or just QE3 if you want to sound “in the know”).

The reason why these countries were looking fragile was:
– They were all running significant balance-of-payment imbalances in 2013 (through excessive and persistent current-account deficits, see chart 1), which needed to be financed by debt portfolio flows (foreign investors bringing in US dollars to buy local bonds).
– Debt portfolio flows tend to flock to where inflation-adjusted interest rates are more attractive than in US Treasuries. That was not the case of the fragile five and, therefore, foreign investors had no incentive to buy the local bonds of these countries.

Chart 1: Improving trend in current-account balances of selected emerging economies

Current-account balance in % (negative numbers are deficits)



Source: Bloomberg, Vontobel

Then there were four

Out of the original fragile group, the most successful country in delivering on its promises is Indonesia, making it the most remarkable emerging-market (EM) success story of the 21st century. Strong and inclusive growth, unabated reform momentum, stable politics, credible institutions, virtuous economic policies, there is nothing not to like for foreign investors. From June 2013 to June 2022, Indonesia’s current-account balance went from –3.2% to +0.9% of GDP and the yield on the ten-year government bond in real terms (nominal yield minus inflation rate) from +1.0% to +5.9% (October 2022 data). And that’s how the fragile five became the fragile four.

Then there were three

At the time of the taper tantrum, India was dealing with many serious structural problems: mass corruption, failed government services, poor infrastructure, ailing banking and energy sectors, just to name a few. However, since 2014, the market-friendly economic policies instituted by Prime Minister Narendra Modi’s administration led to a drastic improvement of the external accounts and allowed part of the remaining current-account deficits to be financed by foreign direct investments, which are a much more stable source of financing than portfolio flows. This gave the Reserve Bank of India the opportunity to accumulate a massive amount of foreign-exchange reserves, now large enough to cover almost 12 months of imports.

From a pure current-account perspective, India is still the least solid of the ex-fragile five due to its heavy dependence on oil imports, but its situation has improved. From June 2013 to June 2022, India’s current-account balance went from –5% to -2.1% of GDP and the ten-year government bond real yield from –2.7% to +4.2% (October 2022 data). And that’s how the fragile four became the fragile three.

Then there were two

Brazil never had a real problem with its balance of payments since it started piling up on foreign-exchange reserves 20 years ago. Back in 2013, the most serious issues were excessive credit growth (subsidized by state banks), a set of hazardous economic policy experiments, and a shocking overvaluation of the Brazilian real, which had spurred on a frenzied picking up of imported goods. All that was cured by the ensuing deep recession.

Since then, the Brazilian real lost two-third of its nominal value against the US dollar, or half of its value after adjusting for the inflation differential, and the external imbalances automatically adjusted. Problem solved. From June 2013 to June 2022, Brazil’s current-account balance went from –3.4% to –2.0% of GDP and the ten-year government bond real yield from +3.7% to +8.9% (October 2022 data). And that’s how the fragile three became the fragile two.

Then there was one

Since the global financial crisis of 2008/2009, South Africa has suffered from a stagnation of per-capita income, high unemployment, and vast income inequality. Beyond the economic challenges that most emerging economies would normally be facing anyway, South Africa's development has been profoundly undermined by the corrupt networks of "state capture" entrenched under former president Jacob Zuma.

Things changed in 2018 when Cyril Ramaphosa became president. His plans to revive economic growth by tackling corruption, poverty, inequality, and unemployment will probably need several electoral cycles to pay off (assuming his successors follow the same reform path). However, the better investment climate, improved commodity terms of trade, and higher contribution of agriculture to the export basket are reasons to be optimistic. From June 2013 to June 2022, South Africa's current-account balance went from –5.2% to +1.7% of GDP and the ten-year government bond real yield from +1.4% to +8.0% (October 2022 data). And that's how the fragile two became the fragile one.

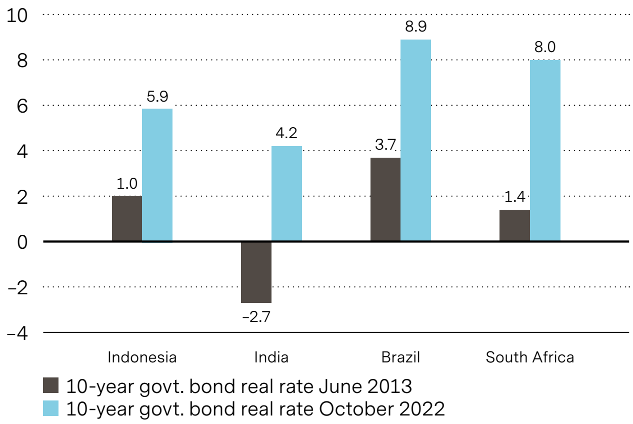
The remaining struggler

No longer is Turkey your typical emerging country. Illiberal populism and governmental delusions of grandeur instilled toxic economic policies resulting in a balance of payment crisis and rampant inflation. At –3.9% of GDP in June 2022, the current-account balance is not looking that alarming but the level of net foreign-exchange reserves is as low as it was back in 2004 when the country was emerging from a deep banking crisis. As for the ten-year government bond real yield, that's now around a shocking minus 68% (October 2022).

Turkey is a beautiful country with a vibrant and diversified economy where local entrepreneurs are famous for their trading acumen. It is also a geopolitical powerhouse, a major strategic nexus between East and West, and a leading arbitrator in regional conflicts. Turkey is one of those essential countries (Egypt is another one) that nobody wants to see falling into chaos. We can only hope the situation stabilizes and turns around soon but, right now, it's not a poster-child emerging economy.

Chart 2: "Compelling quartet" bonds with a hefty edge over US ten-year counterparts in yield terms

Real yield advantage in % vs US 10-year Treasury



Source: Bloomberg, Vontobel

Solid account balances and stellar rates

There's no getting around the fact that the global economy is in a brittle state with fear of recession, inflation, and geopolitical crises wobbling investor confidence. However, out of the original fragile group, while Turkey's economy is more whirling dervish than Turkish delight, it's Indonesia, India, South Africa, and Brazil who have solidified their economies to an extent that they can no longer be classified as fragile.

Our purpose here is not to paint too rosy a picture of emerging economies. Challenges still exist and the appetite for risky assets in general will stay subdued until global inflation pressures start to abate, and China's economy eventually resumes firing on all cylinders. But for bonds issued by emerging economies in their respective local currencies, the narrative that triggered the prolonged selloff from 2013 to 2021 is over. Current-account deficits are a fraction of what they used to be, and EM local interest rates look stellar versus those in developed markets. This means there is yield on offer, real yield. Just look at the real yield differential compared to US Treasuries ranging from +4.2% (India) to +8.9% (Brazil) shown in chart 2. With the smaller external financing needs and much higher yields now on offer, it makes a convincing case to look at the "compelling quartet".

Nowhere to hide—but some segments hold promise

—
Frank Häusler
Chief Investment Strategist,
Vontobel

From bad to worse, followed by bad. Fixed-income investors have truly nowhere to hide this year. The more resilient ones will see this year as an opportunity to prove their mettle. We retain our neutral view on the fixed-income segment and reiterate all sub-asset class views.

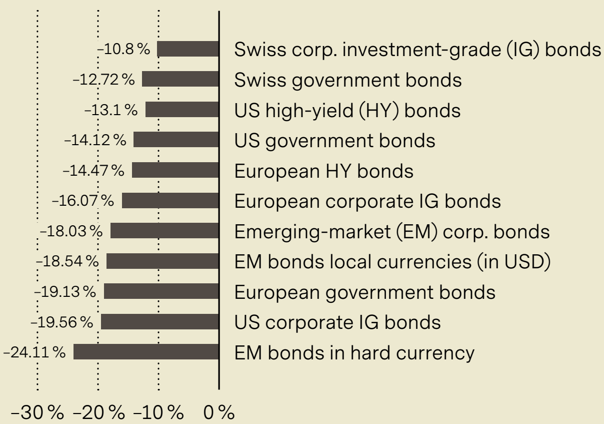
The inflation picture hasn't yet brightened on broad front. While headline US readings show signs of abating after peaking this summer, underlying inflation (so-called core inflation) will take longer to come down. However, we see first indications that the robust US labor market is about to weaken. The path of inflation (rather down) and the path of unemployment (rather up) will give the US Federal Reserve a window to become less restrictive in early 2023.

Political uncertainty remains a worry
What hasn't changed either is elevated geopolitical uncertainty. Russia's war on Ukraine has now entered its ninth month with no end in sight. The East-West dichotomy is set to widen even further. After being handed a third term, Chinese President Xi Jinping has vowed to lead China to a global leadership position by 2049.

This brings us to emerging-market bonds, which have witnessed another material sell-off, particularly in the hard-currency compartment (see chart 1). That said, we retain a slightly positive view for emerging-market debt in hard currency, where valuations have retrenched to the point of being rather attractive.

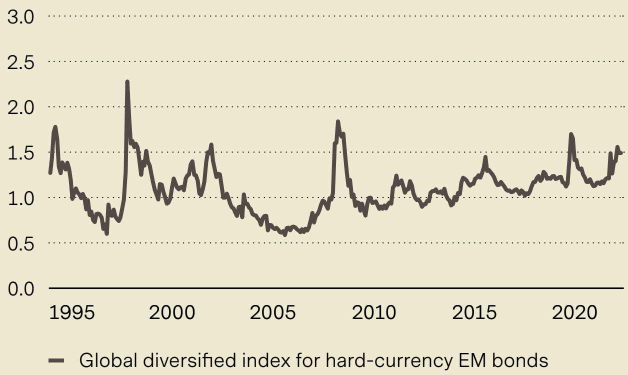
Swiss franc-denominated bonds hold their own
On the more conventional side of fixed income, i.e. the developed-market bulk bracket, we continue to prefer government bonds over investment-grade (IG, rated neutral) and high-yield (HY) issues, which we underweight. The IG and HY spreads—the yield difference to low-risk benchmark bonds—have widened, but their prices may need to fall further before attracting buying interest.

Chart 1: Emerging-market debt getting hammered this year, Swiss corporate paper less affected
Year-to-date total returns in USD



Source: Refinitiv Datastream, Vontobel (data as of October 26, 2022)

Chart 2: After a sell-off, emerging-market bonds in hard currency draw interest again
Spread (rating-adjusted) in %



Source: Bloomberg, Refinitiv Datastream, Vontobel

Surprisingly strong quarterly results, but weigh your next steps

—
Stefan Eppenberger
Head of Multi Asset Strategy, Vontobel

The recent earnings season didn't disappoint and was partly responsible for the stock market rally since mid-October. Even so, corporate earnings will remain under pressure in the coming months due to a slowing global economy. This means that investors should carefully weigh their next steps.

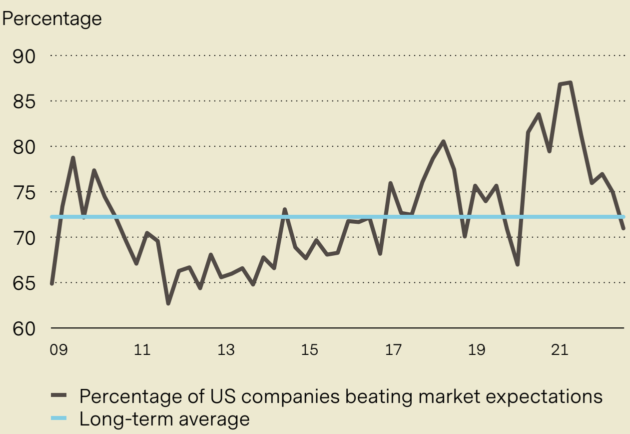
Since mid-October, stock markets have rebounded a good 10% from their lows. The latest rally is reminiscent of the one in summer, which led to even bigger price jumps. Both recoveries happened against the backdrop of extreme pessimism among investors and hopes for a less restrictive US monetary policy. Then as now, surprisingly good quarterly results of listed companies were another supporting factor. At the time of writing, approximately 70% of the US companies that published third-quarter earnings beat market expectations. This is slightly lower than in previous quarters, but near the long-term average (see chart 1). Investors were pleased enough and put in buying orders.

Profits pumped up by energy sector's gains
What leaves a bitter aftertaste is that expectations had been revised downward in advance. And even if profits grew by 2.2% year-on-year on average, stripping out those of energy companies—inflated by soaring energy prices—left the market staring at a 5.1% decline in profits. Among the main victims were companies already struggling with soaring costs. The strong US dollar was an occasional negative factor too as it depressed US corporate profits earned overseas. By contrast, companies with strong brands were able to shrug off higher expenses by raising selling prices, sometimes by up to 20% in the consumer staples sector. Once inflation starts falling off the cliff, as we expect, many companies should benefit. At the same time, past monetary policy tightening and the ensuing economic slowdown will continue to weigh on profits. We believe analysts will lower their earnings estimates further (see chart 2).

That said, equities should have a prominent place in portfolios. That's what our slight overweight implies. While bulls usually start stomping their hooves before analysts upgrade their earnings forecasts, the equity market will wait for a clear improvement in the economic outlook before taking off. Particularly cyclical stocks, where earnings depend on the economic cycle, will need such a nod.

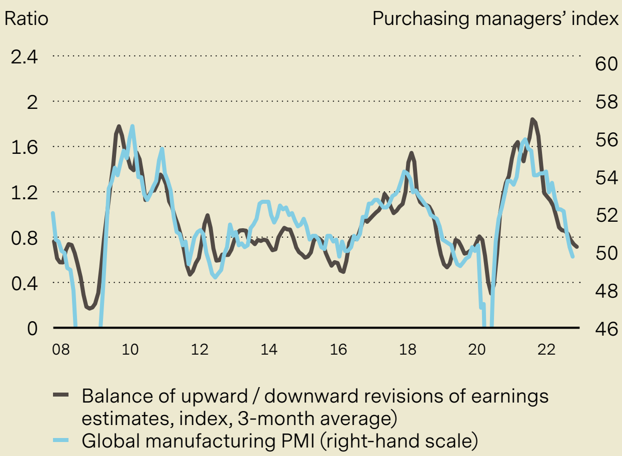
Other sectors will need a nod from the US Federal Reserve. We expect the heavily battered so-called growth stocks as well as certain defensive names—shares of companies in life sciences or food production where customer demand is mostly stable—to outperform once the US central bank changes tack. Therefore, we remain tactically overweight in American and Swiss markets with their impressive line-up of growth and defensive stocks.

Chart 1: US third-quarter corporate earnings were considered satisfactory



Source: Refinitiv Datastream, Vontobel

Chart 2: With economy slowing and earnings outlook worsening, analysts are likely to cut forecasts



Source: Refinitiv Datastream, Vontobel

Saudi Arabia holds the key to crude-oil production

—
Stefan Eppenberger
Head of Multi Asset Strategy, Vontobel

Production cuts by the Organization of the Petroleum Exporting Countries (OPEC) have stabilized the oil market recently. A price floor appears to have formed at approximately 80 US dollars. With member states no longer trying to grab market share via cheaper offerings, oil prices look set to rise in the long term.

Caught in a slowing economy that depresses oil demand (see chart 1), oil prices trade below levels prior to Russia's invasion of Ukraine. And the level around 80 US dollars is fair, according to financial markets, which focus more on growth concerns than multi-year lows in global inventories—theoretically a positive for oil. Meanwhile, the downward trend that began last June seems to have stopped. The main reason was OPEC's flagging of production cuts.

The black gold may have stopped falling, but depending on which period you look at, the price is still high enough. So why is the Saudi-led group apparently trying to push a pricey commodity even further up? OPEC cited the aim to offset the negative effect of a drop in global oil demand on its members' budgets. The cartel also said that higher prices would provide an incentive to develop new oil projects. Both arguments cannot be dismissed out of hand, but don't really hold water. For instance, OPEC's unusual willingness to actively support the industry, competitors included, raises eyebrows. This is hardly credible, especially because relations between Saudi Arabia and the United States have deteriorated sharply since President Joe Biden took office.

More probably, OPEC's move is motivated by self-interest. Saudi Arabia, the undisputed leader of the group, has a rapidly growing young population that is increasingly high-maintenance. This requires a large budget—and where else to find revenues but in the oil and gas industry?

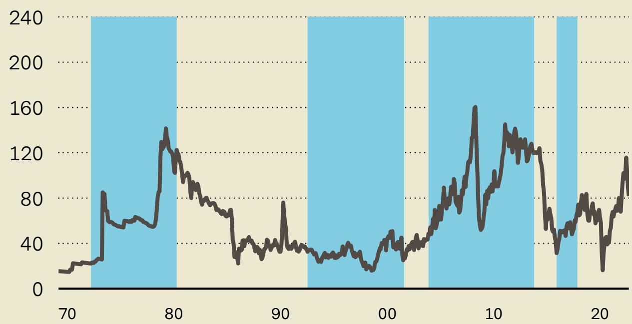
Fight for market share via lower prices is over
What's more, the fight for market share among OPEC member states via lower prices is over. That kind of tussle was on during the Covid-19 pandemic. Another price-supportive aspect is the decline in investment into production capacity by countries outside the "OPEC plus" group (OPEC and Russia) for reasons such as increased regulation, the ongoing energy transition away from fossil fuels, and shortages of materials as well as labor. This is especially true for the shale oil industry in the US, which had been booming before Corona.

As things stand, a more powerful OPEC (read: Saudi Arabia) can easily increase its global market share, a situation which has led to higher oil prices in the past (see chart 2). For that, Riad even appears ready to vex Washington.

Chart 1: US oil demand has come back significantly in recent months
Millions of barrels per day

Source: Energy Information Administration (EIA), Refinitiv Datastream, Vontobel

Chart 2: Oil prices move higher as a rule when OPEC's sway increases
In USD



Source: Energy Information Administration (EIA), Refinitiv Datastream, Vontobel

Franc up, yen down—but look at its long-term strength

—
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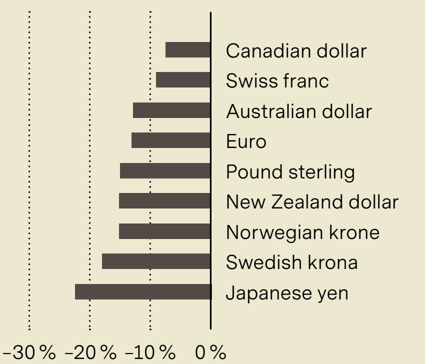
Never mind its miserable year-to-date performance, the Japanese yen is the second-strongest currency after the Swiss franc since the breakdown of the Bretton Woods agreement in 1973. While its long-term robustness counts nothing right now, the Japanese currency may soon recover once the Bank of Japan (BoJ) changes tack. The Swiss franc looks set to remain strong.

The relatively low upward pressure on producer and consumer prices in Switzerland and Japan, which led to a gain in both countries' competitiveness, has been a long-term plus for both currencies. The yen's extraordinary weakness so far this year (see chart 1) can be explained by a level of central bank "dovishness" that surprised even the Japan bears among market watchers. The BoJ's unwavering defense of the government bond yield curve (read: massive bond purchases) sent the currency to lows that prompted an intervention by the finance ministry on the foreign-exchange market. Though the yen may suffer some more in the near term, the situation should normalize via falling US rate expectations (USD-negative, yen-supportive) or a less loose Japanese monetary policy.

Solid Swiss foothold
Stepping out of the European Central Bank's (ECB) shadow, the Swiss National Bank (SNB) started an aggressive policy tightening cycle that preceded similar moves by the bigger Frankfurt-based peer. The Swiss franc managed to appreciate against the euro on the back of the European energy crisis and looming recession risks. Due to Switzerland's more diversified energy mix and lower dependence on Russian deliveries, part of the Swiss corporate sector saw its relative competitiveness rise significantly, which compensated for the negative effect from the franc's appreciation. Prospects of continued upward pressure on energy prices may keep the Swiss currency well supported in the next few months.

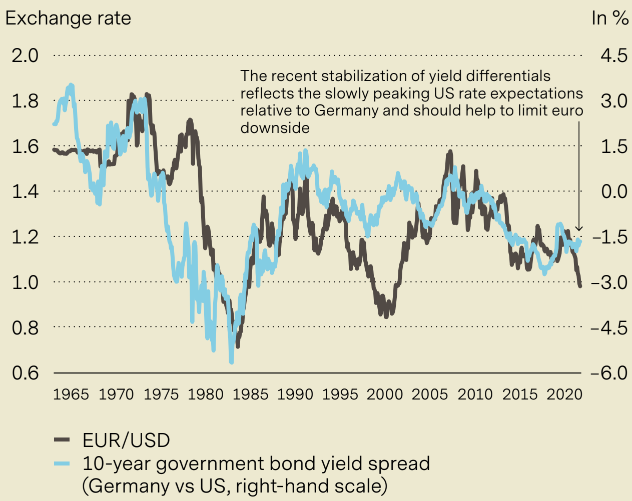
Dollar rally at an advanced stage
The US dollar is likely to lose an important ally this winter, rate expectations. The most aggressive policy tightening cycle since Paul Volcker's Fed tenure in the 1980s has been a major driver of the astonishing 2021/22 USD rally, which saw it gain 22% against the euro and in trade-weighted terms since June 2021. Even though the Fed disappointed hopes for a more accommodating policy in early November, US base rates aren't likely to rise much further, we believe. Across the Atlantic, the ECB has good reasons to remain hawkish amid still rising inflation rates in most euro zone economies. At what stage the EUR/USD exchange rate may turn will also depend on the war in Ukraine, European energy prices, and the extent of the global economic slowdown. However, it seems that we are entering the final phase of dollar strength.

Chart 1: The Japanese yen is the main decliner among developed-market currencies this year
Year-to date currency performance versus USD



Source: Refinitiv Datastream, Vontobel (data as of October 31, 2022)

Chart 2: Interest rate differentials are no longer dollar-supportive



Source: Refinitiv Datastream, Vontobel

Economy and financial markets 2020 – 2023

The following list shows the actual values, exchange rates and prices from 2020 to 2021 and consensus forecasts for 2022 and 2023 for gross domestic product (GDP), inflation / inflationary expectations, key central bank interest rates, ten-year government bonds, exchange rates and commodities.

GDP (IN %)	2020	2021	CURRENT[1]	2022 CONSENSUS	2023 CONSENSUS
Global (G20)	–2.6	5.2	1.7	2.4	2.0
Eurozone	–6.3	5.3	0.2	3.0	–0.1
USA	–3.4	5.7	1.8	1.7	0.4
Japan	–4.7	1.8	1.6	1.6	1.4
UK	–9.3	7.2	0.2	4.2	–0.4
Switzerland	–2.5	3.8	2.5	2.2	0.8
Australia	–2.1	4.9	0.9	4.0	2.0
China	2.2	8.1	3.9	3.3	4.8

INFLATION	2020	2021	CURRENT[2]	2022 CONSENSUS	2023 CONSENSUS
Global (G20)	1.7	3.3	7.4	7.3	5.0
Eurozone	0.3	2.6	10.7	8.3	5.6
USA	1.2	4.7	8.2	8.0	4.1
Japan	0.0	–0.3	3.0	2.3	1.5
UK	0.9	2.6	10.1	9.0	6.3
Switzerland	–0.7	0.6	3.0	2.9	2.0
Australia	0.9	2.9	7.3	6.4	4.5
China	2.5	0.9	2.8	2.2	2.4

KEY INTEREST RATES (IN %)	2020	2021	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR	–0.50	–0.50	1.50	2.48	2.40
USD	1.75	0.25	4.00	4.85	4.35
JPY	–0.10	–0.10	–0.10	–0.04	–0.06
GBP	0.75	0.25	3.00	4.20	4.15
CHF	–0.69	–0.76	0.50	1.36	1.31
AUD	0.75	0.10	2.85	3.35	3.30
CNY	4.35	4.35	4.35	4.30	4.30

GOVERNMENT BOND YIELDS, 10 YEARS (IN %)	2020	2021	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR (Germany)	–0.6	–0.20	2.29	2.29	1.92
USD	0.9	1.50	4.15	3.83	3.44
JPY	0.0	0.10	0.26	0.21	0.22
GBP	0.2	1.00	3.56	4.09	3.69
CHF	–0.5	–0.10	1.18	1.66	1.42
AUD	1.0	1.70	3.85	3.95	3.50

FOREIGN EXCHANGE RATES	2020	2021	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS END OF 2023
CHF per EUR	1.08	1.04	0.99	0.97	1.00
CHF per USD	0.88	0.91	1.00	0.99	0.95
CHF per 100 JPY	0.86	0.79	0.68	0.70	0.70
CHF per GBP	1.21	1.23	1.13	1.09	1.12
USD per EUR	1.22	1.14	0.99	0.98	1.05
JPY per USD	103	115	147	142	135
USD per AUD	0.77	0.73	0.64	0.65	0.70
GBP per EUR	0.90	0.84	0.88	0.89	0.88
CNY per USD	6.51	6.37	7.19	7.20	7.00

COMMODITIES	2020	2021	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
Brent crude oil, USD per barrel	52	78	98	95	92
Gold, USD per troy ounce	1,898	1,822	1,671	1,718	1,800
Copper, USD per metric ton	7,749	9,740	7,561	7,131	8,200

[1] Latest available quarter
[2] Latest available month, G20 data only quarterly
Source: Vontobel, respective statistical offices and central banks; as of November 4, 2022

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