Letter from CIOs

MANUELA D'ONOFORIO – HEAD OF GROUP INVESTMENT STRATEGY
PHILIP GISDAKIS – CHIEF INVESTMENT OFFICER GERMANY
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The price of freedom

The terrible war in Ukraine is keeping the world on tenterhooks, while its economic impact is being felt accross markets. Although European stock indices have recovered noticeably from the sharp price losses in March, price fluctuations remain high. In addition to the effects of the war and the sanctions – in particular, the sharp price fluctuations for oil, gas and other raw materials – other developments are also dampening sentiment across stock markets. For example, the Federal Reserve's (Fed) intention to tighten its monetary policy more significantly is depressing prices in the US. And in Europe, China's zerocovid policy is spoiling the mood, as the rigid lockdowns are likely to lead to further disruptions in global supply chains. Europe's industrial structure, which is heavily geared towards foreign trade, will suffer particularly as a result.

Looking at the MSCI equity indices, the Europe index (traded in EUR) has suffered price losses of around 6% since the beginning of the year*, while the US market has lost 11%. The Pacific barometer (which tracks stock markets of the industrialized countries) shows a loss of 14%, as the Emerging Markets that show a loss of 15%. German stocks have lost almost 12% and Chinese 21% (all non-European indices are denominated in USD, and the Chinese one in Yuan). Bond markets did not look much better. The government bond index for the euro area has fallen almost 9% against the backdrop of increased inflation expectations and arguably more aggressive central bank action, and yields have risen noticeably in mirror image. This means that the performance of so-called multi-asset portfolios with both equities and bonds has suffered accordingly, and both asset classes were hit by rising yields.

However, in our view, this is no reason for investors to bury their heads in the sand. While the aforementioned risk drivers (such as energy price pressure, inflation, and supply chain bottlenecks) are dampening economic activity and market sentiment, the outlook for European and US companies nevertheless does not appear to be bad. For example, although the International Monetary Fund (IMF) has noticeably lowered its growth forecast for the euro area as a result of the Ukraine war and further pressures, it still expects GDP growth rates of 2.8% and 2.3%, respectively, for 2022 and 2023. Both figures are above the average growth of the five years before the pandemic. For the US, the IMF projects 3.7% and 2.3%, respectively. The 5-year average growth of 2015-2019 is 2.4%.

In addition, according to consensus estimates, corporate earnings are still expected to show robust growth. Taking into account these earnings expectations and the current share price declines, the valuation levels of global equities have eased significantly. The price-to-earnings (P/E) ratio of the MSCI Europe, for example, is just under 13, whereas at the peak of the post-pandemic it was over 18. The P/E ratio of the MSCI North America has also declined noticeably (currently: just under 18, interim high: 23), but it is still at the upper end of the valuation range of the 15 years before the pandemic. However, the higher US growth compared with Europe and the fact that the Ukraine war and its economic consequences are affecting the US much less than Europe speak in favour of US equities.

The planned stronger tightening of US monetary policy – the Fed has announced significant interest rate increases and a noticeable reduction in its bond holdings – is weighing on US equities, especially highly valued technology stocks, but the economic environment still appears quite robust. It is not for nothing that the Fed thinks that the significant tightening of monetary conditions is advisable, but economically bearable.

Nevertheless, we expect volatility in financial markets to remain high, at least for the current quarter. Further (manageable) setbacks cannot be ruled out. However, the economic picture could brighten in the second half of the year. Phases of rising Fed interest rates are usually not bad for equities. Historically, a significant burden has typically only arisen when the central bank has had to cut interest rates again in view of a deteriorating economic outlook. Such recession risks in the US, triggered by excessive tightening of monetary policy, are currently being debated. However, we are probably still a long way from such a situation.

In Europe, citizens are also suffering from high inflation, but unlike in the US, price pressure is essentially coming from the energy side and supply chain bottlenecks. Both are factors that cannot really be influenced by a central bank with its instruments. In this country, the risks of a wage-price spiral are manageable. Moreover, the European economy should benefit from the inevitable investments in a more broadly based and sustainable energy infrastructure and in a European security architecture.

So, there is no reason for investors to hide. The medium-term outlook appears favourable. However, tangible potential returns are also needed to avoid real losses in purchasing power. In the short term, however, European equities no longer appear overpriced after the recent price reductions, despite continuing price fluctuations. Moreover, experience teaches that volatile times are not a bad time to look for medium-term return opportunities. Despite the simultaneous pressures on bonds and equities in recent months, investors with well-diversified portfolios – even taking currency positions into account – were able to achieve total returns that were significantly less negative than the separate performance of European equities and bonds. This shows that well-diversified and broadly positioned portfolios bring a certain stability even in difficult times. Building on this stability, it could then also be possible to realise return potential for the future.