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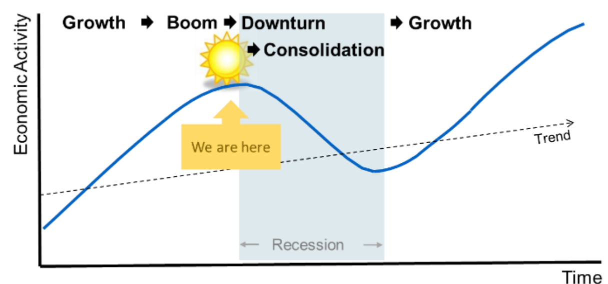
Briefing from the ARVEST Investment Committee

In the first quarter of 2023, the global economy experienced a period of relative stability. The global supply bottlenecks caused by the pandemic and geopolitical tensions have largely dissipated. Logistics chains have adapted to the new conditions and production has increased. Europe has avoided an energy emergency by reducing its dependence on Russian gas and has benefited from a mild winter. China has also made a 180-degree turn in its Covid policy, abandoning its zero-tolerance strategy toward the virus. This decision reflects China's new economic priorities aimed at boosting growth and strengthening domestic demand. Chinese population mobility surged accordingly in early February after the end of Chinese New Year. Japan's economy stagnated due to the lingering effects of imported inflation, which the Bank of Japan, unlike other central banks, did not combat with interest rate hikes.

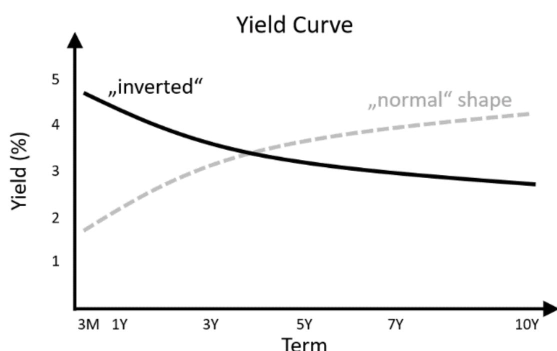
Inflation declined worldwide, but remained at a high level. In the USA in particular, labour markets and wage pressures remained strong, despite the Fed continuing its restrictive interest rate policy.



Future Prospects

We continue to expect the U.S. economy to reach its growth peak in the next two quarters before slipping into recession. However, this may not be ascertainable until late 2023 or early 2024. We see the reasons for this primarily in the continued overheating of the U.S. economy after a long period of zero or negative interest rates globally and the interest rate hikes of the past 12 months, which were stronger and faster in the U.S. dollar than ever before in our lifetimes. In the past, such restrictive financial conditions have led to recessions with a corresponding lag. A recession in the U.S. is likely to affect other regions that depend on the US economy or show similar problems.

Indeed, leading indicators in the recession models we track continue to warn strongly of a recession in the United States. For example, the U.S. Treasury yield curve has been perfectly inverted since mid-March 2023. This means that the yield on 6-month notes is lower than the yield on the shorter 3-month notes. The 1-year Treasury bonds, in turn, yield less than the 6-month notes, and so on up to a 10-year maturity.



An inversion of yields between two maturities at any point in the yield curve is an extraordinary phenomenon that normally occurs only before recessions. Moreover, since the 1960s, a perfectly inverted yield curve had occurred only before the recessions in 1973, 1980, and 1981. Indeed, in normal times, yield curves are not inverted because longer-term loans are riskier and therefore more expensive. Banks then benefit from the fact that they can grant longer-term loans at higher interest rates than they have to pay for short-term bank deposits. Today's perfectly inverted yield curve, on the other hand, makes lending unattractive for banks.

In this context, banks act as a transmission mechanism between the monetary policy and the real economy. The recent turbulence at some banks (Silicon Valley Bank, Signature Bank, Credit Suisse) may have been the first harbingers of a coming recession. In our view, however, banks are in a better position today than they were before the 2008 financial crisis, not least because lending was less excessive this time. During the zero interest rate policy and also during Covid, many projects were also financed with equity. In addition, the Fed launched a contingency program (BTFP[1]) on March 12 to provide liquidity to U.S. banks failing to deal with their liquidity and interest rate risks. We therefore believe a systemic banking crisis is unlikely. However, the yield curve is likely to remain inverted or flat. Indeed, we expect inflationary pressures to persist, limiting the Fed's room for interest rate cuts. If the U.S. economy weakens only slightly, the Fed will probably not be able to cut short-term interest rates as much as it would be desirable. We remain vigilant, as even a prolonged unfavourable interest rate environment can lead the real economy into recession without being triggered or exacerbated by a banking crisis.

We have already reduced the equity quota in the portfolios and are now keeping it stable. For us, however, quality stocks with safe and sustainable dividends as well as a genuine global diversification of investments remain indispensable. In our view, it is still too early for a "full" re-entry into the equity market. Medium-term bonds with low default risk appear comparatively attractive to us. Long-term bonds, on the other hand, may not price in sufficient inflation risk. It remains to be seen whether the next upswing will again be accompanied by global deflation.

11 April 2023
On behalf of the Investment Committee
Stefan Kimmel
Chief Investment Officer ARVEST Funds AG

[1] **B**ank **T**erm **F**unding **P**rogram

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