Our View in January

12 January 2021

VP BANK

Banking on the recovery

The financial markets have started with confidence into the new year. A hard Brexit has been avoided and the signs for 2021 are in favour of a recovery despite the high Corona case numbers.

There is no sign of taking a breather or slowing down. The stock markets made further strong gains in December and the first few days of January. The defining theme is the expected economic recovery. Further impetus has been given by the fact that crucial political issues have been resolved.

Whether it was the Brexit trade agreement or the Democrats in the US winning the run-off elections for the two Senate seats in Georgia, the results were positively received by the markets. As justified as the optimism for 2021 might be, and as much as we pointed out the reasons for it in our December investment magazine Telescope entitled "The Green Recovery", a healthy degree of caution is advisable in our view.

The Corona virus still has a firm grip on our lives and politics in the here and now. And the Capitol riot in Washington has drastically demonstrated how deeply divided American society is. The wild swings in Bitcoin's price over the past few days are also a stark reminder that financial markets are not a one-way street.

At the turn of the year, we have adjusted the strategic investment quotas in asset management and feel encouraged by the the latest developments. With a strategic increase in the equity quota, we are banking on the economic upswing in the coming years and consider alternative investments to be essential in order to be prepared for setbacks. In particular, we consider insurance-linked securities (ILS) to be a very useful part of the asset allocation in the current year.

Dr Felix Brill, **Chief Investment Officer**

Our View on the **Portfolio**

- **Shorter duration** to reduce interest rate risks
- **European equities** with catch-up potential
- Attractive insurance premiums for **insurance-linked securities**

- **Government bonds** remain unattractive beyond the diversification effect
- Tactical restraint on **USD bonds**

Money market	● ● ● ● ●
Bonds	● ○ ○ ○ ○
• Government bonds	● ● ○ ○ ○
• Corporate bonds	● ● ● ○ ○
• USD bonds	● ● ○ ○ ○
• Emerging markets	● ● ● ○ ○
Equities	● ● ● ○ ○
• Switzerland	● ● ● ○ ○
• Europe	● ● ● ● ○
• USA	● ● ● ○ ○
• Japan	● ● ● ○ ○
• Emerging markets	● ● ● ○ ○
• Themes	● ● ○ ○ ○
Alternative assets	● ● ● ○ ○
• Hedge funds	● ● ● ○ ○
• ILS	● ● ● ○ ○
• Convertible bonds	● ● ● ○ ○
• Gold	● ● ● ○ ○

● ● ● ● ● Strong overweight
● ● ● ○ ○ neutral
● ○ ○ ○ ○ Strong underweight

Base: Mandate CHF balanced

Our View on the **Economy**

- The distribution of a **vaccine** promises a gradual return to normality during 2021
- The low interest rate environment continues to provide a tailwind for the **construction industry**
- The public sector is ready to **provide generous** financial relief

- Due to the particular anatomy of the Corona recession, **catch-up effects will be weaker**
- The recovery is hampered by **rising insolvency numbers**
- The sharp **widening of budget deficits** will constrain fiscal policy in the future

Lean economic diet at the beginning of the year

The Covid-19 pandemic is putting a strain on economic development in the first quarter. Around the globe, new and even stricter protection measures are being taken. In many countries, particularly in Europe, gross domestic product (GDP) will therefore shrink in the first three months of the year. On the other hand, a second large relief package in the US is a positive. The government checks for private households and smaller businesses will keep the US economy afloat in the coming months. Likewise, the newly won majority of the Democrats in the US Congress promises more government stimulus this year. Finally, vaccination programmes have been set up in many countries which should allow for a gradual return to normality in the second half of the year. So 2021 promises improvements but it won’t be straightforward.

Our View on **Monetary policy**

- The end of expansionary monetary policy has **not yet been reached**
- Despite a recently unchanged policy, the **Fed is ready to act** at any time

- Central banks' arsenal will be **limited in the future**
- Increasing risk of **asset bubbles**

Fed will not move for the time being

The Fed has seen no reason to change its monetary policy stance at the last meeting. Yet it stressed that it will continue the securities purchase programme until substantial progress has been made in the labour market and regarding inflation. This at least extends the time horizon of quantitative monetary policy, since there has only been talk so far of "several months." Given the European Central Bank's renewed easing, there were expectations that the Fed would step up its measures as well. With the US economy performing relatively well in the face of adverse circumstances, Fed Chairman Jerome Powell did not see the need to act. Powell insisted that Congress would adopt, as it later did, another relief package. The Fed's calculation is likely to be that no additional monetary policy stimulus is needed if financial policy is used.

Our View on **Government Bonds**

underweight

- The ECB's net purchase volume **covers the net debt issuance** of government bonds in 2021
- **Euro-periphery bonds** may benefit
- Government bonds help to **diversify a portfolio**

- Government bond issuance has increased massively
- Rising public debt ratios are likely to **worsen** sovereign **credit quality**
- Government bonds carry a **high interest rate risk**

Majority for Democrats lifts US yields

The Democrats' victory in the runoff for the two Senate seats in the US state of Georgia had a significant impact on the yield of 10-year Treasury bonds as yields have returned to above 1%. The market participants seem to think that the US President-elect Joe Biden will be able to set his political agenda to motion to the greatest extent possible with the congressional majority. Biden's large-scale infrastructure programme would lead to higher debt and thus a larger bond supply. However, it remains to be seen whether Biden will actually push through extra spending with a majority of just one vote in the Senate against Republican criticism. He will probably seek consensus. Nevertheless, at least part of the infrastructure programme is likely to be drawn up. We believe that the expectations of market participants are justified.

Our View on **Corporate bonds**

neutral

- Central banks have **unlimited resources** to buy corporate bonds
- The **low interest rate environment** is likely to continue for a long time
- Further fiscal **relief measures** to support the economy will be provided if necessary

- Fundamental data have **deteriorated significantly** as a result of the pandemic
- Number of **credit rating downgrades doubled in 2020** compared to the previous year
- Support for central banks could be called into question if **inflation risks** emerge

Be prepared for potential downgrades

Corporate indebtedness has risen sharply since the financial crisis. Despite record-low interest rates, an increasing number of companies are unable to pay their interest from cash flow. An analysis by the Fed New York shows that Covid-19 has accelerated this process. Credit rating agencies respond with a review of the credit rating and issue outlooks which are equivalent to potential up- or downgrades. The gap between such potential downgrades and upgrades has never been so big. At present, the outlook for 1224 companies is negative (up from 600 last year) . On the other hand, the outlook is positive for only 161 (250 a year ago). We do not think that a compensation of less than 1% for investment grade bonds and 3.5% for high yield bonds is sufficient in this environment. We expect that, sooner or later, central banks will allow a controlled increase in the risk premium.

Our View on **Equities**

neutral

- An end to the global health crisis seems close **with vaccines being administered**
- Fiscal policies strengthen **growth momentum**

- The temporary euphoria in stock markets can lead to **higher price fluctuations**
- Equities in the **technology and Internet consumption** segments appear overvalued

Optimistic mood

Despite the global health crisis, investors are looking to the future. Their focus is on tangible solutions and the willingness of states to provide support to the ailing economy. Likewise, uncertainties such as those around Brexit, are diminishing, and the change of government in the US promises a return to proven diplomatic practices in international politics. The fundamental valuation have been cooled down by improved profit growth prospects, and the rapid pace of digitisation supports global profitability and optimisation of existing and the emergence of new business models. Europe and the emerging economies in Asia offer the most attractive catch-up potential, Switzerland offers high quality and stable yields.

Our View on **European equities**

overweight

- The **EU reconstruction plan** together with the new EU budget make more than EUR 1.8 trillion available under the fiscal financing framework for the next seven years
- European equities are **attractively valued**

- The **health crisis** is not yet under control
- Certain tensions in **international trade** remain unresolved

Stronger together

The pandemic appears to be bringing decision-makers in the European Union (EU) in line. If a federal debt structure was unthinkable at the beginning of last year, it will now enter into force just as much as a trillion-dollar fiscal stimulus package. It seems that Europe is moving forward after all.

The stock markets in Europe are well placed, because the fundamental valuations are as low as the profit expectations of market participants. In this constellation, small progress is already sufficient to achieve great effects. Expected growth in mobility, rapid digitisation and a focus on infrastructure renewal create opportunities across the whole spectrum of the European economy. This should also be beneficial to European stock markets.

Our View on **Alternative Assets - ILS**

neutral

- **Performance independent** of financial markets and the economy
- **Higher premiums** after damage in the past
- Excellent **diversification**

- **Risk of major losses** due to unusually severe natural disasters
- Does **not benefit from recovery** when the corona virus is overcome
- The greatest risk is a hurricane over the Florida metropolis, e.g. Miami

Excellent outlook for 2021

The first forecasts for the 2021 Atlantic hurricane season have already been published. Seven hurricanes (three of them severe) and 16 designated storms are expected. This is about average comparing with the last ten years. Last year, 13 hurricanes and 30 designated storms were recorded, due to the weather phenomenon La Niña. It was only the third time that six hurricanes made landfall in the US. Fortunately, in most cases, this happened in sparsely populated areas. The damage at USD 60-65 billion was high, but fell well short of USD 278 billion in 2017. Some of these damages are not insured or covered by insurance. The remaining damage that was paid to Insurance-linked Securities (ILS) was lower than expected. Compared to 2020, insurance premiums are significantly higher today. The outlook for 2021 is therefore excellent.

Our View on **Currencies**

- **USD:** The recent sharp devaluation of the Greenback suggests a backlash
- **GBP:** The Brexit deal opens up further appreciation potential for sterling
- **AUD:** Benefits from China's Economy

- **Emerging-market currencies** benefited only partially from the weakness of the US dollar due to a difficult fundamental situation
- The **Turkish lira** remains weak
- **CHF:** The signs are for depreciation against the euro

Dollar weakness looks over-stretched

The USD is now in a descent that has lasted for more than eight months. There are now a whole series of indicators signalling a consolidation or even backward movement. The positioning of speculative investors on a continued weakness of the USD as a counter-indicator warrants particular caution. But the deviation from the broad dollar index to the two-year rolling median also shows that the bow may be overstretched in the short term. We are sticking to our view of a longer-term weakness in the US dollar. In the short term, however, we are expecting a consolidation which may also entail a short-term strength of the US currency.

Authors and Disclaimer

Authors:

Dr. Felix Brill, Dr. Thomas Gitzel, Bernhard Allgäuer, Harald Brandl

Important legal advice