Our View in November

10 November 2020

VP BANK

Hope in the midst of the Covid-Crisis

The second wave of Covid infections has got us under control. But there is hope. Progress in vaccine development has been greeted euphorically by the markets. After the US election, a new relief program is also within reach.

There are exciting days behind us. The outcome of the US presidential election seemed narrower than the final result will probably be owing to the time-consuming counting of the many votes. But that does not stop the incumbent President Donald Trump from ignoring the election result. In a flood of lawsuits, he is trying to discredit the elections.

Financial markets are not worried. This is also due to the fact that, despite the run-off for the two Senate seats of Georgia, a majority for the Democrats in the Senate is an unlikely scenario. This will make it more difficult for Democrats to govern. Possible tax increases are therefore off the table. On the other hand, a new relief program is still within reach. The compromise plan is an impressive $1.5 trillion.

Far more than after the US election, the stock markets have reacted positively to news about the development of a Covid vaccine. Although there is no guarantee that the first promising results of the studies will be confirmed, the response shows two things: First, an early end to the corona pandemic was not yet fully priced in, despite the impressive recovery in stock markets. Second, expectations remain more important for investors than the here and now.

This means for the portfolio: to diversify in order to benefit in a recovery, but not to be caught off the wrong foot by possible setbacks. This is reflected by the tactical allocation which has been confirmed by the Investment Committee.

Dr. Felix Brill, **Chief Investment Officer**

Our View on the **Portfolio**

- Shortening the duration of the portfolio by means of an increased **cash** ratio
- Neutral weighting in **equities** with a focus on long-term trends
- **Gold** as insurance for the portfolio

- High interest rate risk continues to make **government bonds** unattractive
- Deteriorating solvency burdens **corporate bonds** and **US dollar bonds**

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

Base: Mandate CHF balanced

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

Our View on the **Economy**

- In the **third quarter** strong growth rates have been recorded
- **Short-time work compensation** in Europe and government payments in the US help private consumption
- **Monetary policy** continues to support

- **Second wave of infections** and **lockdown measures** test recovery in Europe
- Recovery is also hampered by rising **insolvency numbers**
- The sharp widening of **budget deficits** will constrain fiscal policy in the future

Second wave threatens economic recovery

The second wave of Covid-infections is still hindering Europe. With the numbers of beds used in intensive care rising sharply, governments are forced to resort to new lockdown measures. Economic side effects, especially in services, are to be expected. In the US, too, new infections are rising rapidly. However, no major economic disturbances have been identified. But this is just a snapshot. Individual states could soon impose containment measures again. A difficult winter is already looming. Additional state support measures are likely in our view. All eyes are now on the President elect Joe Biden.

Our View on **Monetary policy**

- The ECB will increase measures
- The Fed may soon follow suit

- Central banks' arsenal will be limited in the future
- Risk of valuation distortions have increased

ECB runs up bond purchases before the end of the year

The European Central Bank (ECB) is seeing bad weather ahead due to the second wave of Covid-infections following the impressive economic recovery in the third quarter. By December, monetary policy measures will be taken on the basis of updated growth and inflation projections. According to the ECB's President Christine Lagarde, all the policy instruments are being used as needed. It is likely that all purchasing programs will be increased. Improved terms of the targeted long-term refinancing operations are on the cards as well as reductions in negative interest rates for commercial banks. It is not certain whether the deposit rate will also be lowered. We do not expect that.

Our View on **Government Bonds**

Highly underweighted

- The second wave of infections could boost **demand for government bonds** once again
- Government bonds **diversify** a portfolio

- The **supply** of government bonds has increased enormously
- Rising public debt is likely to **worsen** sovereign **credit quality**
- Government bonds carry a **high interest rate risk**

Government debt with a slightly higher yields

Government bonds showed no consistent trend in recent weeks. While yields in the US initially rose somewhat, German government bonds showed a benign tendency with declining yields. The prospect of an expansion of government bond purchases by the European Central Bank (ECB) underpinned market sentiment in Europe. In view of the massive increase in public debt, we consider the risk-return-ratio in this asset class still unfavorable. In our reference portfolios, we respond to this in two ways: To reduce interest-rate risk, we prefer shorter duration. At the same time we are underweight compared to the strategic target. How fast it can go was seen after the news on the Covid vaccine. Ten-year US Treasury bonds soared from below 0.8% to almost 1.0%.

Our View on **Corporate Bonds**

underweighted

- **Central banks** have virtually unlimited means to buy corporate bonds
- The **low interest rate environment** is likely to continue for a long time to come
- More **public support** possible

- **Fundamental data** have deteriorated markedly due to the pandemic
- **Downgrading** of credit ratings doubled in 2020 compared to the previous year and is expected to continue
- Central-bank support will eventually be challenged with **inflationary risks** emerging

Pandemic lowers solvency

The Covid-19 crisis hits corporate debtors' balance sheets and earnings with full force. A study by the New York Fed confirms that solvency (as measured by the "interest-coverage ratio") has deteriorated significantly. On average, this number has fallen from 4.7x to 3.5x in the first quarter. In addition, a quarter of the companies have a ratio of less than 1. This means that profits are insufficient to meet interest-rate obligations. These figures are even worse in the sectors of retail, entertainment and restaurants which have been particularly hit. With declining state support, it becomes tight for many debtors. So downside risks outweigh the opportunities. At the moment, despite the latest news about a vaccine, it is not clear how long the pandemic will still accompany us and who will pay for the damage. The order of the day is therefore to be picky in the selection process.

Our View on **Equities**

neutral

- The **US election** has boosted stock markets
- **Asia** and **Europe** are expected to benefit most
- Promising news about a **Covid vaccine**

- Currencies in **Brazil**, **India**, **Russia** and **Turkey** are at historic lows, putting pressure on their economies and stock markets

The focus is shifting towards 2021

For the stock markets, this autumn will set the course for the coming year. This is true for the question on how quickly the second Covid wave will be stopped. The jump in equity markets of over 6% in Europe as a response to the news of a possible vaccine shows that an early end to the Corona pandemic has not yet been priced in. Secondly, the election of Joe Biden as the next US-President will have a significant geopolitical impact especially with a view to international trade. Even if new rules are likely to be negotiated hard among both continents, the tone of the negotiations will be different. In our view, Europe and Asia are the main beneficiaries of this change in style.

Our View on **US Equities**

neutral

- Markets speculate that a Republican Senate would prune the Democratic spending program
- Robust corporate profits in the third quarter indicate a recovering US economy

- If Trump succeeds with some of the **lawsuits** regarding the ballot count, this could create new uncertainty
- A Democratic victory in the **run-off** for Georgia's two open senate seats could frighten markets
- The sharp rise in **new infections** could lead to tighter containment measures

The Great Countdown

With Biden being president elect combined with a Republican-led Senate, this seems to be the widely favored market scenario. Because in this constellation hardly any tax increases would have to be expected. These would have led to an estimated earnings impact for companies in the range from 6 to 12 %. But this would be matched by lower fiscal measures, as Republicans oppose a large-scale "Green New Deal ". Nevertheless, companies have shown very good results for the third quarter of 2020, which is an indication of a recovering economy. Likewise, existing industrial trends in the field of digitization are unbroken. The economic environment in the US remains challenging in the light of the second Covid wave, but still offers opportunities for long-term investors.

Our View on **Alternative Investments - Hedge Funds**

neutral

- Hedge funds or regulated absolute return products can be used to build **more robust portfolios**
- Performance **expectations** are achievable if they are adjusted for each product

- The **selection** of managers is challenging
- **Cost** is still (too) high in many cases
- **Measuring performance** is difficult

The agony of choice

Hedge funds don't enjoy a good reputation. This is mostly due to high expectations, but often also to the measurability of the more than 15,000 managers. Among them there are many free riders who reduce the average performance of the asset class. Unfortunately, there are very few managers who delivered consistent and uncorrelated returns. But such managers would be needed in uncertain times as this. We therefore recommend styles which generally have a low correlation to the overall market and thus bring added value in the portfolio context. This need not always be hedge funds, but can also be regulated liquid absolute return products. This will allow more robust portfolios to be built.

Our View on **Currencies**

- **EUR :** EU reconstruction fund provides tailwind
- **CAD:** Benefits from a weaker US dollar
- **AUD:** Benefits from a better economic situation in China

- **USD:** could continue to decline if valuation criteria were to come to the fore
- The **Turkish lira** is under a continued downward pressure
- **GBP:** The British pound is threatened with short-term setbacks when Brexit returns to the headlines

Joe Biden and the Dollar

Whether the transition in the White House will have a lasting impact on the US dollar depends on the run-off for the two Senate seats in Georgia. A large infra-structure program by Joe Biden would continue to strain the US budget deficit. Along with a negative current account, an increase in the twin deficits (budget deficit and current account) would suggest a continued downward pressure on the US dollar. Until the majority of the Senate is established, the new president's power is still unclear, and so is the White House's spending plan. Meanwhile, the situation in Turkey continues to deteriorate. The devaluation of the Turkish lira carries the risk of a balance-of-payments crisis due to a high level of foreign debt.

Authors and Disclaimer

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Important legal advice