Our View in August

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VP BANK

The virus has not been defeated yet

The gold price soaring, the US dollar sinking - the last few weeks have been tough. In this environment, the stock markets have performed differently from region to region. Europe struggled, while the US and emerging markets were able to add gains. Against the background of a renewed rise in Covid-19 infections, we confirm our cautious portfolio stance.

The price of gold has continued its run and easily passed both its all-time high and the USD 2,000 mark per troy ounce. Since the beginning of the year, this has resulted in an increase of more than 30% in US dollar terms. That the price has eased somewhat in recent days is not untypical after such a strong and rapid rise. We read this development as a breather rather than a change of the price trend.

From our point of view, gold is receiving support from various sides: be it from the weakening US dollar, the negative real interest rates or the anxiety of many investors that inflation could rise in the long term after all. Last but not least, we appreciate gold's very good diversifying properties and therefore stick to our long-standing gold positioning.

As much support as we are currently seeing for gold, the US dollar is receiving little or none of that. The greenback is currently facing headwinds. Since we published the first issue of our “Telescope" magazine entitled “The Wimpy Dollar" at the end of May, the US dollar has weakened across the board. As we explained in detail in the magazine (link here), there are good reasons to believe that this was only the prelude to a longer-term phase of dollar weakness. That is why we continue to consistently hedge the US dollar.

Felix Brill, **Chief Investment Officer**

Our View on the **Portfolio**

- The performance of gold this year has been outstanding and is softening the impact of a lower dollar
- Equity themes are helping to get exposure to structural change

- With even more government bonds issued, the case for them is becoming even worse
- Credit risks are elevated for all corporate bond segments

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	● ● ● ● ○

● ● ● ● ● strong overweight
● ● ● ○ ○ neutral
● ○ ○ ○ ○ strong underweight

Base: Mandate CHF balanced

Our View on the **Economy**

- Leading indicators signal a **strong recovery** in manufacturing and the service sector
- Government **support programmes** seem to be effective so far
- **Monetary policy** continues to be accommodating

- Rising number of **insolvencies** could dampen the economic recovery
- Concerns about a second wave of infections could trigger **new lockdown measures**
- An increase in **government budget deficits** will constrain future fiscal policy

Rising infections cast a shadow

The world economy is showing signs of a strong recovery from the Corona crash. However, the strong GDP growth figures expected for the third quarter in the US and the Eurozone should be taken with a pinch of salt, as they are calculated from a much lower base after the strong decline in the second quarter.

The crisis triggered by the Covid-19 pandemic meanwhile acts as an accelerator to structural change in many industries, including the automotive industry. The affected sectors are likely to go through difficult times also after Corona. The recent increase in Covid-19 cases in Europe has led to fears that a second wave of infections is under way. If new lockdown measures were to be re-introduced then this would be a severe blow to the recovery. In the short term, uncertainty is therefore likely to increase.

Our View on **Monetary Policy**

- Money markets **are functioning well again**
- Central banks credibly signal that they **are ready** to take additional action **at any time**
- Financial market participants continue to **trust** central banks

- **No guarantee** that financial markets won’t withdraw confidence from central banks
- Zero and negative interest rates **distort the price of risk**, thereby increasing the risk of **price bubbles**

Phase two has started

Central banks are entering a new phase of crisis management. It is now a question of letting the emergency measures work and analysing their effect. Because of their preventive and decisive interventions, monetary authorities, especially in the US and Europe, are in a comfortable position to wait and see. Should economic data disappoint going forward, or financing conditions deteriorate again, more specific and targeted actions are likely. The ECB could, for example, consider buying bonds from companies whose credit rating has recently deteriorated significantly. This would be primarily a confidence-building measure. The US Federal Reserve has also left the crisis-fighting phase, focusing on getting the numerous emergency credit programmes up and running.

Our View on **Government Bonds**

Strong underweight

- The economic consequences of the Corona pandemic have not yet been fully resolved leading to high **demand for government bonds**
- Government bonds contribute to **diversification** in the portfolio

- **Supply** of government bonds is rising tremendously, which could lead to interest rates spikes going forward
- Rising public debt is likely to jeopardise **credit ratings**
- Government bonds carry a **high interest rate risk**

Significantly higher issuance of government bonds

Central banks have arrived in phase two. Now that the fire has been extinguished, the focus has shifted to controlling the embers. In the short term, therefore, a further substantial expansion of government-bond purchasing programmes is not on the agenda - although one-off measures are possible. On the other hand, there is now a massive increase in the volume of sovereign debt issued. The generous financial assistance provided by the states in the wake of the crisis must finally be financed. Meanwhile, the EU recovery plan includes issuing eurobonds. The recovery fund will then redistribute money from the rich member countries in the north to the indebted countries in the south. Peripheral bonds will benefit from that. Overall, however, we confirm our strong underweight of government bonds.

Our View on **High Yield Bonds**

Currently not included in the model portfolio

- Central banks enjoy the confidence of financial markets, thereby **supporting and steering markets**
- Governments are also ready to **further support** the economy if necessary

- The ratio of downgrades to upgrades in credit ratings is **extreme** and will not be positive in the foreseeable future
- Covid-19 has led to **higher debt levels**. In recessions, companies typically strengthen their balance sheets
- The impact of the virus will be felt harder in some sectors, some will **not recover for years**

Liquidity versus solvency

Companies usually try to strengthen their balance sheets and reduce debt as recessions hit. But during the Covid-19 recession, they did the opposite. As a first reaction, USD 340 billion of credit lines were drawn from banks, which were subsequently repaid by issuing bonds. So will there soon be a feeling of hangover after the debt party? The crisis hits sectors in different intensity and for different periods of time. In general, the lower the quality, the stronger the impact. In US High Yield this year, only 105 credit ratings have been upgraded compared to 926 downgrades so far. But, with central banks buying bonds, markets are neglecting the fundamental reality. The spread on high yield bonds was less than 5%, even though the expected default rate stands at 12.5%. So the question is, how long this type of "planned economy" can last in capital markets.

Our View on **Equities**

underweight

- Companies surprised with **robust second quarter results**
- Strong retail sales **testify to improved consumer confidence**

- Sentiment indicators signal increased risks of setbacks in the short term
- High concentration of price gains on a few stocks; the **market breadth has** significantly **decreased**

Ready for the summer break

The financial figures for most companies for the first six months have been less negative than feared. Neverthe-less, the numbers show drastic effects and an erosion of profit margins. The gradual normalisation of business activity and an improvement in consumer confidence thus indicate a milder economic outcome of the Corona crisis compared to what many analysts had assumed.

By contrast, fundamental valuations are already high, driven mainly by the technology sector and low interest rates. It is expected that the momentum of price increases will diminish and a sector rotation looks increasingly likely. The focus will be on companies whose debt is likely to be somewhat higher but whose business performance was very robust during the crisis.

Our View on **Equities Europe**

underweight

- Big **fiscal support package** will support Europe's economy
- **New car registrations** exceed previous year's level

- Europe suffers from **a high share of cyclical consumption**
- The **stronger euro** against the US dollar affects exporters negatively
- The re-emergence of new infections could lead to **new lockdown measures**

The "old continent" is struggling

The decline in economic performance in Europe at -12.1 % in the second quarter is unique. In particular, in the segment of consumer durables, but also in the tourism and hotel industry, Europe's economy has been hit hard. By contrast, banks are more resilient and better capitalised than during the financial crisis 2008/09. As the trough seems to be behind us, it is clear that Europe with a higher share of old industrial structures has been affected much more than regions with strong technological orientation (including the US, China, South Korea, and Taiwan). The measures taken by the ECB and the EU will support the economy, but the high costs of industrial transformation are likely to exceed the fiscal support significantly. Moreover, as the recent appreciation of the euro is also burden for the export sector, we see European stocks as less attractive than other stock markets.

Our View on **Alternative Investments - Gold**

overweight

- Uncertainty increases **fear-driven investment demand**
- **Low interest rates and inflation risks** serve as an opportunity dividend
- Price momentum and extended stock-market valuations **increase demand**

- The **demand from jewellery and central banks** will recover slowly
- Strong price momentum can lead to **profit taking** in the short term

Citius, Altius, Fortius

Faster, higher, stronger – According to the Olympic Games' motto, gold reached record heights faster than expected, and has recently been able to record prices of more than USD 2,000 an ounce. Once again, the most important price driver was record money inflows into exchange-traded gold funds. Investors buy gold because the US dollar weakens or they fear inflation to rise. By contrast, demand from the jewellery industry fell 53% year on year in the second quarter, and central banks' demand was also markedly lower compared to the record year in 2019. According to the World Gold Council, total demand decreased by 11%. In the futures markets, the net positioning remained unchanged, after both buyer and seller positions increased. We continue to find gold in the portfolio context attractive, but there is a risk of some price reset in the short term.

Our View on **Currencies**

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

- **USD:** Looks weak in the short term
- **BRL:** Brazil's real remains on a downward trajectory due to Brazil's rampant pandemic
- **GBP:** Brexit returns to the forefront, the British pound is threatened with short-term setbacks

Change of tune

The US dollar is weakened. The US is not getting the Corona pandemic under control. The economic reset may thus be bumpy in the US. At the same time, the EU recovery fund to cope with the crisis will stabilise the EU and thus the Eurozone. The US presidential election is now also in the spotlight. Whether Donald Trump can secure a win to stay at the White House is uncertain. This leads to questions about the future course of policies, which is not to taste of currency markets and burdening the greenback. But even under technical considerations, the euro is now receiving support. The moving averages of the past 50 and 100 trading days broke the 200-day line of the EUR/USD exchange rate. This could mean a EUR strength and a simultaneous USD weakness.

Authors and Disclaimer

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